Supreme Court, U.S.
FILED
93 1416 MAR 9 1994
OFFICE OF THE CLERK

No. 93-____

In The Supreme Court of the United States

October Term, 1993

NCR Corporation,
Petitioner,

v.

South Carolina
Department of Revenue and Taxation,
Respondent.

Petition for a Writ of Certiorari to the Supreme Court of South Carolina

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

This case raises the same two questions presented by the petition for certiorari filed by petitioner in *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico,* No. 93-541, which is currently pending before the Court:

1. Whether the prohibition of the Foreign Commerce Clause against state taxes that inevitably cause international multiple taxation precludes a state from taxing a corporation's foreign source interest and royalties on which the corporation has already paid taxes on an unapportioned basis to foreign countries.

2. Whether the fair apportionment requirement of the Commerce and Due Process Clauses precludes a state from including in a corporation's apportionable tax base income received from its unitary subsidiaries without taking account of the subsidiaries' income-producing factors in the apportionment formula.

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, respondent was referred to as the South Carolina Tax Commission. However, effective July 1, 1993, the South Carolina Tax Commission was transferred to and incorporated in the South Carolina Department of Revenue and Taxation pursuant to 1993 S.C. Acts 181, § 1-30-95.

RULE 29.1 STATEMENT

Petitioner NCR Corporation is a wholly-owned subsidiary of American Telephone & Telegraph Company, which itself has no parent corporation. Petitioner's subsidiaries, other than wholly-owned subsidiaries, are as follows:

NCR Ghana Limited

NCR Japan, Ltd.

NCR (Nigeria) Limited

NCR (Thailand) Ltd.

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DEPARTMENT OF REVENUE AND TAXATION,
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Petition for a Writ of Certiorari to the Supreme Court of South Carolina

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PETITION FOR A WRIT OF CERTIORARI

NCR Corporation respectfully petitions for a writ of certiorari to review the judgment of the Supreme Court of South Carolina in this case.

OPINIONS BELOW

The second opinion of the Supreme Court of South Carolina in this case (*"NCR II"*) (App. A at 1a-7a) is not yet reported. The supplemental order on remand of the Court of Common Pleas of Richland County, South Carolina (App. B at 8a-9a) is unreported. The order on remand of the Court of Common Pleas of Richland County, South Carolina (App. C at 10a-25a) is unreported. The first opinion of the Supreme Court of South Carolina in this case (*"NCR I"*) (App. D at 26a-41a) is

reported at 304 S.C. 1, 402 S.E.2d 666 (1991). The final order of the Court of Common Pleas of Richland County, South Carolina (App. E at 42a-67a) is unreported. The Finding of the South Carolina Tax Commission (App. F at 68a-72a) is unreported.

JURISDICTION

The judgment of the Supreme Court of South Carolina in *NCR I*, which decided the first question NCR presents here (*see* p. i *supra*), was entered on February 4, 1991. The court in *NCR I* remanded the case to determine whether NCR was entitled to relief with respect to the second question NCR presents here (*see* p. i *supra*). The judgment of the Supreme Court of South Carolina in *NCR II*, which decided this second question, was entered on December 13, 1993. The now final judgment of the South Carolina Supreme Court carries with it all federal issues properly raised in this case. *Urie v. Thompson*, 337 U.S. 163, 172-73 (1949); *Louisiana Navigation Co. v. Oyster Comm'n*, 226 U.S. 99, 102 (1912). The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const., art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Due Process Clause of the Fourteenth Amendment of the United States Constitution, U.S. Const., amend. XIV, § 1, provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the South Carolina statutes are set forth in App. G at 73a-78a.

STATEMENT

This case—like *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico*, No. 93-541 (petition for certiorari pending)—raises two issues of great significance for state taxation of multistate and multinational corporations. Both arise out of the fact that South Carolina, like most other states, includes in a corporate taxpayer's apportionable tax base income the taxpayer receives from its unitary foreign subsidiaries without taking into account the foreign subsidiaries' income-producing factors in apportioning such income. When, as in this case, the income is received in the form of royalties and interest from foreign subsidiaries, and the recipient has already been taxed on the full amount of that income by foreign countries on an unapportioned basis, the state's failure to provide for "factor representation" of the subsidiaries' factors in the parent's apportionment formula inexorably leads to international multiple taxation. The result is difficult to square with this Court's Foreign Commerce Clause jurisprudence barring state taxes that "inevitably" cause international multiple taxation. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 447 (1979).

The state's failure to provide for "factor representation" also raises a critical issue under the Court's "domestic" Commerce and Due Process Clause jurisprudence. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), the Court explicitly left open the question whether the inclusion of income from unitary subsidiaries in the parent's apportionable tax base required that the subsidiaries' factors be reflected in the parent's apportionment formula. *Id.* at 441 n.15. Justice Stevens, who did address this question, observed that unless the subsidiaries' factors were reflected in the taxpayer-parent's apportionment formula, "the inclusion of earnings attributable to those corporations . . . will inevitably cause [the taxpayer-parent's] . . . income to be overstated." *Id.* at

461 (Stevens, J., dissenting) (footnote omitted). This case provides the Court with an opportunity to resolve this issue, which has spawned division and confusion in the state courts.

1. NCR's Business

The facts of this case are not in dispute.[1] Petitioner NCR Corporation is a Maryland corporation with its corporate headquarters and principal place of business in Dayton, Ohio. NCR is engaged in the manufacture and sale of business information processing systems, including cash registers, automated bank tellers, and computers. NCR conducts "an integrated unitary business nationwide and worldwide." App. D at 28a n.1. All phases of NCR's worldwide business are conducted partly within and partly without South Carolina.

In foreign countries, NCR conducts its business directly through branch offices and indirectly through subsidiary corporations. During the years at issue (1981-83), NCR had approximately 18 branch offices and 75 foreign subsidiaries doing business in over 150 foreign countries. With one exception, the foreign subsidiaries were 100 percent owned by NCR. None of the foreign subsidiaries did any business within South Carolina.

2. NCR's Royalty and Interest Income Received from Its Unitary Foreign Subsidiaries

NCR received substantial royalty and interest income from its unitary foreign subsidiaries. The royalties arose from patents and licensing agreements under which NCR's foreign subsidiaries were entitled to manufacture and sell business machines in various foreign countries. The interest arose from various loans that NCR made to its foreign subsidiaries. For the years in question, the

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[1] Except as otherwise indicated, the following statement of facts is drawn primarily from the South Carolina Supreme Court's statement of facts in *NCR I*. App. D at 27a-29a.

amounts of royalties and interest NCR received from its foreign subsidiaries were as follows:

Year	Royalties	Interest
1981	$34,167,013	$18,331,361
1982	$40,906,977	$16,839,715
1983	$52,095,171	$ 6,010,449

Record on Appeal in *NCR II* at 160.[2]

During the years at issue, NCR paid $15,484,917 in income taxes to foreign countries upon the royalties and interest in question. Tr. of Record in *NCR I* at 211.[3] These foreign income taxes were unapportioned levies on the full value of all royalty and interest amounts received by NCR from its foreign subsidiaries. App. D at 27a. At the same time that foreign countries imposed unapportioned foreign income taxes on these royalties and interest, South Carolina imposed an apportioned tax upon the identical royalties and interest. App. D at 28a-29a.

3. South Carolina's Taxing Scheme

South Carolina imposes its corporate income tax upon the "net income" of every domestic corporation and every foreign corporation doing business in the state. S.C. Code Ann. § 12-7-230 (Law. Co-op. 1976 & Supp. 1993) (App. G at 73a). During the years at issue, a corporation's "net income" was defined as its gross income less deductions allowed for South Carolina tax purposes. *Id.* § 12-7-600. Corporations whose principal busi-

[2] The amounts set forth above differ slightly from those cited by the court below in *NCR I* (*see* App. D at 28a), because the amounts set forth in the text above represent gross royalties and interest paid to NCR whereas the amounts set forth in *NCR I* represent taxable royalties and interest net of related expenses.

[3] The foreign income taxes imposed upon NCR were in addition to the taxes that NCR's foreign subsidiaries paid to foreign countries on their own income. App. D at 27a.

ness was manufacturing and selling, and who derived income from interstate activities, were required to apportion, on the basis of a three-factor formula, all income that was not specifically allocated.[4] *Id.* §§ 12-7-230, 12-7-1140 to 12-7-1170 (App. G at 73a-76a). Under this formula, the taxpayer's income was apportioned to South Carolina by the average ratio of its property, payroll and sales in South Carolina to its property, payroll, and sales everywhere. *Id.* § 12-7-1140 (App. G at 75a-76a).

4. The Assessment

In filing its South Carolina tax returns for the years at issue, NCR took two alternative positions. First, it excluded from its taxable net income the royalties and interest it received from its foreign subsidiaries (App. E at 48a) on the theory that, under the Foreign Commerce Clause, South Carolina could not include the royalties and interest in NCR's apportionable tax base because the full amount of such income was subject to tax on an unapportioned basis by foreign countries.[5] South Carolina's taxation of even an apportioned share of such income, NCR maintained, would inevitably lead—and in

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[4] Although South Carolina does not use the familiar distinction between apportionable "business" income and allocable "nonbusiness" income that is employed in the Uniform Division of Income for Tax Purposes Act, 7A U.L.A. 331 (1985), its statutes follow a similar pattern by allocating various classes of income (including royalties and interest "not connected with" the business of the taxpayer) and apportioning the taxpayer's remaining net income (including royalties and interest received from unitary subsidiaries, which are at issue here). S.C. Code §§ 12-7-1120 to 12-7-1140 (Law. Co-op. 1976 & Supp. 1993) (App. G at 74a-76a).

[5] NCR also based its position on the theory that a tax on its foreign source royalties and interest prevented the United States from "speaking with one voice" in regulating foreign commerce. See App. E at 53a-54a. NCR does not press this argument before this Court.

fact had led—to international multiple taxation in violation of *Japan Line*. Alternatively, NCR contended that, if the disputed income were includable in NCR's apportionable South Carolina tax base, then, under both the Commerce and Due Process Clauses, the income-producing factors of NCR's foreign subsidiaries should be reflected in the formula employed to apportion NCR's income. App. E at 57a. Upon audit, the South Carolina Tax Commission (the "Commission")[6] rejected both NCR's Foreign Commerce Clause and its "factor representation" arguments.[7] Following a hearing, the Commission denied NCR's protest and issued an assessment of taxes and interest for income tax years 1981-83 (and for license fee years 1982-84) of $499,007.[8]

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[6] Effective July 1, 1993, the South Carolina Tax Commission was transferred to and incorporated in the South Carolina Department of Revenue and Taxation pursuant to 1993 S.C. Acts 181, § 1-30-95.

[7] In filing its 1981 return, NCR excluded its foreign royalties and interest from the apportionable tax base and argued for "factor representation" in the alternative. App. E at 44a. In filing its 1982 and 1983 returns, NCR included the foreign royalties and interest in the apportionable tax base while also including the foreign subsidiaries' payroll, property, and sales in its apportionment formula. *Id.* NCR renewed both of these positions for all of the years at issue when it challenged the tax assessment in the Court of Common Pleas, *see infra* p. 8, which reviews tax protests *de novo*. *See* J. von Lehe & F. Boyle, *South Carolina Income Taxation* I-4 (3d ed. 1987).

[8] Tr. of Record in *NCR I* at 3-4. Of the total assessment for taxes and interest, $492,982 was attributable to the income tax (*id.* at 3), and $6,025 was attributable to the license tax (*id.*), which is an annual tax based on capital employed in South Carolina. S.C. Code Ann. § 12-19-70 (Law. Co-op. 1976 & Supp. 1993) (App. G at 76a-77a). The license tax base includes NCR's investments in its foreign subsidiaries but is apportioned by the same formula prescribed for the income tax (*id.* § 12-19-80 (App. G at 77a-78a)), which takes no account of such subsidiaries. NCR's constitutional objections to the South Carolina income tax apportionment formula are therefore equally applicable to the license fee apportionment formula, and its petition for review of the

5. The Decision Below

a. Court of Common Pleas (*NCR I*)

NCR filed a timely complaint in the South Carolina Court of Common Pleas, challenging the assessment on the grounds, among others, that the tax violated the Commerce and Due Process Clauses. Tr. of Record in *NCR I* at 6. The court rejected NCR's Foreign Commerce Clause contention that the South Carolina tax resulted in inevitable international multiple taxation, even though NCR's royalties and interest had already been taxed abroad. It reasoned that "[t]he mere fact that interest and royalty income are [*sic*] included in the preapportionment base does not mean that South Carolina is, in fact, taxing that specific income." App. E at 49a The court also rejected NCR's alternative Commerce and Due Process claim for "factor representation." It declared that "even if a 65.8% increase" (*id.* at 64a) in NCR's tax could have been attributed to the failure to include the foreign subsidiaries' factors in NCR's apportionment formula, "such is not a sufficient increase to violate Due Process or Interstate Commerce." *Id.*

b. Supreme Court of South Carolina (*NCR I*)

The Supreme Court of South Carolina affirmed in part and remanded in part. App. D at 41a. With respect to NCR's Foreign Commerce Clause claim, the court acknowledged that many of the foreign countries in which NCR's subsidiaries do business "impose an unapportioned tax on NCR on the full value of all royalty and interest amounts earned by NCR and paid to it by its foreign subsidiaries." *Id.* at 27a. It also recognized that South Carolina's taxation of even an apportioned share of these royalties and interest would result in "actual double tax-

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judgment below is directed to both taxes. Because of the relative insignificance of the license fee, however, no further reference will be made to it in this petition.

ation" (*id.* at 35a), just as California's apportioned tax resulted in multiple international taxation in *Japan Line*. Consequently, it conceded that "*Japan Line* appears to support NCR's position here" (*id.* at 32a)—at least if it is "[r]ead in isolation." *Id.*

The court nevertheless found *Japan Line* distinguishable from the instant case on the same grounds that this Court had distinguished *Japan Line* in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). App. D at 35a. In *Container*, the Court sustained California's worldwide unitary combined reporting method as applied to a United States multinational corporation over the objection, *inter alia*, that it resulted in multiple international taxation in violation of the strictures of the Foreign Commerce Clause articulated in *Japan Line*. In addressing this claim, the Court in *Container* observed that "the double taxation in this case, although real, is not the 'inevitabl[e]' result of the California taxing scheme." *Container*, 463 U.S. at 188 (quoting *Japan Line*, 441 U.S. at 447). It also observed that the tax in *Container* was on income and fell on a domestic corporation, whereas the tax in *Japan Line* was on property and fell on a foreign corporation. *Container*, 463 U.S. at 187-89.

The South Carolina Supreme Court found that "[t]he same distinguishing factors exist which make *Japan Line* inapplicable in the instant case." App. D at 35a. Thus, it was "unconvinced that double taxation is 'inevitable' under the South Carolina taxing scheme" (*id.*), although it did not explain why South Carolina's apportioned tax on the royalties and interest did not inevitably lead to multiple taxation when those royalties and interest had already been taxed in full abroad. The court also noted that "[t]his is not a property tax case" (*id.*) and that "the tax here falls on a domestic corporation, not a foreign corporation." *Id.* The court did not indicate, however, how these "distinguishing factors" of *Container* served to differentiate *Japan Line* from the instant case

with regard to the question of "inevitable" multiple taxation.

While rejecting NCR's Foreign Commerce Clause claim, the court did find merit in NCR's contention that South Carolina could not constitutionally include the royalty and interest income that NCR derived from its foreign subsidiaries in NCR's apportionment formula without also including the subsidiaries' factors in NCR's apportionment formula. It observed that "South Carolina's taxing scheme is not ideally fair" (App. D at 39a) because the royalties and interest in question were earned, at least "[t]o a degree" (*id.*), in foreign countries, yet South Carolina took no account in the apportionment formula of the out-of-state factors that generated this income. The court thus recognized the principle that inclusion of income from subsidiaries in the parent's apportionable tax base " 'should be balanced by some changes in the formula denominator.' " *Id.* at 39a (citation omitted). Nevertheless, because the court believed that NCR would be entitled to an adjustment in the apportionment formula only if it could demonstrate that failure to provide for such an adjustment would result in "gross distortion" (*id.* at 40a), the court remanded the case to the Court of Common Pleas for a "refactoring of the formula, considering in the formula . . . the proportionate measure . . . of the foreign subsidiaries' property, payroll, and sales which generated the NCR income." *Id.* The Supreme Court of South Carolina instructed the Court of Common Pleas to compare NCR's tax liability with and without "factor representation" and to grant relief only if there were a "gross disparity . . . of constitutional proportions" (*id.*) between the two amounts.

c. Court of Common Pleas (*NCR II*)

On remand, the Court of Common Pleas found that including a proportionate share of the subsidiaries' property, payroll, and sales in NCR's apportionment factors reduced NCR's South Carolina tax liability as follows:

	1981	1982	1983
Old tax	$190,879	$264,541	$426,600
New tax	$138,001	$216,977	$344,948
Difference	$ 52,878	$ 47,564	$ 81,652

App. C at 21a. The court further found the resulting percentage increases from failing to permit "factor representation" were as follows:

	1981	1982	1983
Difference	$ 52,878	$ 47,564	$ 81,652
New tax	$138,001	$216,977	$344,948
% increase	38.3%	21.9%	23.6%

Id. The average increase for the three tax years at issue was 27.9 percent. *Id.*[9]

Despite the existence of a systematic overstatement of NCR's taxes of, on average, some 28 percent as a result of failing to account for the subsidiaries' factors in NCR's apportionment formula, the court concluded that this did not amount to "[g]ross distortion of a constitutional magnitude." *Id.* at 23a. Moreover, the trial court explicitly rejected NCR's argument that, regardless of the size of the distortion percentage, the state's formula was unconstitutional because it " 'is inherently unfair, [and] inevitably results in taxation of substantial extraterritorial values on an ongoing basis . . . .' " App. B at 9a (quoting Plaintiff's Memorandum of Law at 2).

d. Supreme Court of South Carolina (*NCR II*)

The Supreme Court of South Carolina affirmed. Evidently viewing NCR's argument regarding the inherent

[9] For purposes of this petition, NCR is not contesting the validity of the "re-factoring" methodology employed by the Court of Common Pleas, although NCR challenged the validity of that method before the court. Significantly, however, the trial court found that NCR's "burden of showing a 'gross distortion' " (App. C at 24a) of constitutional magnitude was so heavy that, even assuming NCR's methodology was correct and the average distortion for the three years was 51 percent, *id.*, NCR would not have established a constitutional violation.

unfairness of the state's formula as constitutionally irrelevant, the court simply ignored it. Instead, relying on this Court's opinion in *Container*, the court dismissed NCR's claim of a right to "factor representation" in a few brief paragraphs. App. A at 5a-7a. The court observed that this Court in *Container* had rejected a constitutional challenge to an apportioned tax on the ground that a 14 percent increase in taxable income fell " 'within the substantial margin of error inherent in any method of attributing income among the components of a unitary business.' " *Id.* at 6a (quoting *Container*, 463 U.S. at 184). It viewed this Court's opinion in *Container* as establishing an "acceptable" (*id.*) level of distortion and noted that "[o]ther state courts have upheld similar or larger margins of error." *Id.* at 6a-7a. And it concluded that the 28 percent overtaxation of NCR resulting from the failure to provide for "factor representation" did not rise to the level of a "gross disparity" (*id.* at 7a) violating constitutional strictures.

REASONS FOR GRANTING THE PETITION

The judgment of the Supreme Court of South Carolina warrants review by this Court for three compelling reasons. First, the court's decision condoning international multiple taxation is incompatible with this Court's Foreign Commerce Clause jurisprudence and, if left undisturbed, would undermine essential restraints on state tax power. At the very least, this Court's guidance is needed to clarify the distinction between taxes that are constitutionally intolerable under *Japan Line* and those that can survive constitutional scrutiny under *Container*. Second, the state court's reliance on a gross distortion test to deny NCR's right to representation of its unitary subsidiaries' factors in its apportionment formula, despite the inclusion in NCR's apportionable tax base of income earned by those factors, disposed of a critical issue that this Court explicitly left open in *Mobil* and has created a conflict among state courts of last resort. The Court should

address this issue and resolve the conflict. Third, the issues of both international multiple taxation and "factor representation" present recurring questions of profound practical importance that merit plenary consideration in their own right.

I. THE STATE COURT'S DECISION CONDONING INTERNATIONAL MULTIPLE TAXATION THAT INEVITABLY RESULTS FROM SOUTH CAROLINA'S TAXING SCHEME CANNOT BE RECONCILED WITH THIS COURT'S FOREIGN COMMERCE CLAUSE JURISPRUDENCE

In *Japan Line*, this Court held that the Foreign Commerce Clause barred a state from imposing a fairly apportioned personal property tax on cargo containers that had been taxed on an unapportioned basis abroad. Although the tax would have passed muster under the Court's Interstate Commerce Clause doctrine, 441 U.S. at 445-46, the Court held that the tax violated the more exacting demands of the Foreign Commerce Clause. Under the Foreign Commerce Clause, "a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation." *Id.* at 451. In addition, a court must determine "whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Id.* The Court observed that "[i]f a state tax contravenes *either* of these precepts, it is unconstitutional under the Commerce Clause." *Id.* (emphasis supplied).

As the South Carolina Supreme Court recognized, if *Japan Line* controls this case, it plainly "appears to support NCR's position here." App. D at 32a. Just as Los Angeles County in *Japan Line* sought to subject the taxpayer to an apportioned tax on property that a foreign country had taxed on an unapportioned basis, so, too, in this case South Carolina seeks to subject NCR to an apportioned tax on income that foreign countries have already taxed on an unapportioned basis. *Id.* at 27a-29a.

In an effort to deflect the force of this analogy, the state court relied on *Container*, which concerned California's apportioned income tax on the combined income of a multinational group of corporations. The taxpayer challenged the tax on the ground that, when considered in conjunction with taxes imposed on such income by foreign countries, California's levy subjected the income to international multiple taxation in violation of the Foreign Commerce Clause. In sustaining the tax, this Court found that the international multiple taxation it had condemned in *Japan Line* was constitutionally tolerable in *Container* principally because the double taxation in *Container* "although real, is not the 'inevitabl[e]' result of the California taxing scheme." *Container*, 463 U.S. at 188 (quoting *Japan Line*, 441 U.S. at 447).[10]

The state court's reliance on *Container* is misplaced. The multiple taxation in *Container* was not "inevitable" because it resulted from two different methods of dividing the tax base, which was comprised of the worldwide income of Container and its subsidiaries. California employed formulary apportionment as a means of dividing this tax base, whereas other countries used separate accounting as a means of dividing this tax base. "Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case." *Container*, 463 U.S. at 188.

In *Japan Line* and the instant case, by contrast, there was no effort by the foreign taxing jurisdictions to divide the tax base—the property in *Japan Line*, the royalties and interest here. Rather, the taxing jurisdictions allocated 100 percent of the tax base to themselves. Consequently,

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[10] The Court also distinguished *Japan Line* on the ground that it involved a property tax rather than income tax and that the taxpayer was foreign rather than domestic. *Id.* at 187-89. But these factors were largely subsumed within the Court's analysis of whether the international multiple taxation in *Container* was "inevitable" and hence intolerable.

when Los Angeles County or South Carolina sought to impose an apportioned tax on the same tax base, multiple taxation was "inevitable." Because foreign countries subjected 100 percent of the relevant base to tax, *any* apportioned tax imposed by another jurisdiction would result in multiple taxation. In short, we are not dealing here, as the Court was in *Container*, with two different methods of "divid[ing] the pie." *Id.* Rather, here (as in *Japan Line*) the entire pie has been subjected to tax by foreign jurisdictions, which leaves the states no room to tax even an apportioned slice.

There is a further point of distinction between *Container* and the instant case that accounts for the inevitability of the multiple taxation here. In *Container*, the combined income *and the combined factors* of Container and its unitary foreign subsidiaries were considered in determining the income that was properly attributable to California. Hence there was no certainty that, by including the foreign subsidiaries' income in the apportionable tax base, California would in fact *tax* such income. Rather, as a result of the inclusion of the foreign subsidiaries' factors in the apportionment formula, the income apportioned to California could decrease, increase, or remain the same.[11]

Here, by contrast, while the royalties and interest that NCR derived from its unitary foreign subsidiaries were included in its South Carolina apportionable tax base, the factors of those subsidiaries that earned the income were ignored in apportioning the income to South Carolina.

[11] When a state considers both the income and factors of foreign subsidiaries in the apportionment, two things happen: first, the apportionable tax base *increases*, because of the inclusion of the foreign subsidiaries' income; second, the apportionment percentage *decreases*, because the foreign subsidiaries' property, payroll, and sales add to the denominators, but not the numerators, of the corporation's apportionment factors for the taxing state. Thus, depending on the relative impact of these two changes, the income apportioned to the state will decrease, increase, or remain the same.

Consequently, there was dead certainty that South Carolina would *tax* a portion of every dollar of royalties and interest that NCR received from its foreign subsidiaries,[12] and, accordingly, dead certainty that there would be international multiple taxation when such income was taxed on an unapportioned basis by foreign countries.

The court below was simply wrong in failing to recognize that South Carolina's taxing scheme gave rise to inevitable multiple taxation. Although it properly recognized that there was double taxation in this case, App. D at 27a-29a, the court provided no satisfactory explanation why such double taxation was not "inevitable" or why *Container* was controlling. Without further analysis, it declared simply that it was "unconvinced that double taxation is 'inevitable' under the South Carolina taxing scheme." App. D at 35a. Perhaps hedging its bets, the court went on to suggest that "[e]ven if we were convinced that the tax resulted in inevitable double taxation, we doubt, in light of the other facts clearly distinguishing this case from *Japan Line*, that the taxing scheme should be struck down." *Id.* at 35a n.4. But the court cited no authority—and we know of none—for the proposition that such "other facts" could ever justify inevitable multiple taxation of foreign commerce.

Finally, insofar as there are differences between this case, *Japan Line*, and *Container*, they underscore the need for the Court's consideration of this controversy. *Japan Line* articulated the principles limiting state taxation of foreign commerce, but, in contrast to this case, in the context of a property tax rather than an income tax. *Container* applied those principles to an income tax, but, in contrast to this case, in the context of a worldwide combined tax base where the subsidiaries' factors were fully represented. This case provides the Court with an oppor-

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[12] When income is added to the apportionable tax base without modifying the factors employed to apportion such income, the necessary result is to tax a portion of such income. *See* note 11 *supra*.

tunity to apply *Japan Line*'s principles to a tax on income which has been taxed by foreign countries but with respect to which "factor representation" has been denied. The Court's review is necessary to delineate these principles in a manner that displays greater sensitivity to Foreign Commerce Clause concerns than did the court below and to provide guidance for state courts regarding the meaning of "inevitable" multiple taxation.

II. THE STATE COURT'S RULING THAT INCOME FROM UNITARY SUBSIDIARIES MAY BE INCLUDED IN THE APPORTIONABLE TAX BASE WITHOUT INCLUDING THE SUBSIDIARIES' FACTORS IN THE APPORTIONMENT FORMULA DISPOSES OF THE ISSUE THAT THIS COURT LEFT OPEN IN *MOBIL* AND CREATES A CONFLICT AMONG STATE COURTS OF LAST RESORT

In *Mobil,* this Court held that a state could include within the apportionable tax base of a nondomiciliary corporation the intangible income that it received from its subsidiaries as long as the taxpayer and its subsidiaries were engaged in a unitary business. Although the taxpayer in *Mobil* had resisted that conclusion, it claimed that if the income it received from its subsidiaries was constitutionally apportionable on the theory that it was engaged in a unitary business with its subsidiaries, then such income should have been apportioned under a method that included the subsidiaries' factors in the apportionment formula.

The Court declined to reach this question because it was not timely raised. *Mobil,* 445 U.S. at 441 n.15; *see also id.* at 449. Justice Stevens, however, did address the question in his dissent, where he declared:

> Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable

> tax base will inevitably cause [the payee's in-state] income to be overstated.

Id. at 461 (Stevens, J., dissenting). The Court has subsequently expressed similar sentiments by observing that the fair apportionment requirement demands that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container,* 463 U.S. at 169. *See also id.* at 168 n.5 (recognizing Justice Stevens' views in *Mobil*).

The logic of Justice Stevens' dissent in *Mobil* is irrefutable. If a state fails to account for the factors of a taxpayer's out-of-state subsidiaries that generate apportionable income, the state will inevitably attribute to itself too much of the taxpayer's income. Since the factors outside the taxing state are disregarded, the consequence is to apportion all of the income by reference only to those factors that are taken into account, thereby over-assigning income to those factors. In other words, the formula gives credit to the taxing state for activities occurring elsewhere by disregarding the factors associated with these out-of-state activities.

In holding that South Carolina could include NCR's royalties and interest received from its unitary foreign subsidiaries in NCR's apportionable tax base while denying NCR the right to include in its apportionment formula the subsidiaries' factors that generated the income, the court below has improperly relied on *Container*'s "gross distortion" test to sustain a theoretically indefensible formula. In so doing, the court has disposed of the issue that this Court left open in *Mobil* and has created an irreconcilable conflict with decisions of other state courts. The Supreme Court of Maine and the Wisconsin Court of Appeals have each recognized a taxpayer's right to "factor representation" when income received from subsidiaries is included in the taxpayer's apportionable tax base. *Tambrands, Inc. v. State Tax Assessor,* 595 A.2d 1039 (Me. 1991); *American Tel. & Tel. Co. v. Wisconsin Dep't of Revenue,* 143 Wis. 2d 533, 422 N.W.2d 629

(Ct. App. 1988). The Supreme Court of Rhode Island has recognized a similar principle with respect to partnership income received by a corporation. *Homart Dev. Co. v. Norberg*, 529 A.2d 115 (R.I. 1987). Other courts, however, have agreed with the South Carolina Supreme Court that "factor representation" is not constitutionally required, at least in the absence of a demonstration by the taxpayer that failure to provide for "factor representation" produces a "grossly distorted result." *NCR Corp. v. Taxation and Revenue Dep't*, 115 N.M. 612, 856 P.2d 982 (Ct. App. 1993), *petition for cert. filed*, 62 U.S.L.W. 3289 (U.S. Oct. 5, 1993) (No. 93-541); *Ashland Pipe Line Co. v. Marx*, 623 So. 2d 995, 1004 (Miss. 1993); *NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 544 A.2d 764 (1988); *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn.), *cert. denied*, 493 U.S. 848 (1989).[13]

In *Tambrands*, the question was whether Maine could constitutionally include dividend income that the taxpayer received from its unitary foreign subsidiaries in the taxpayer's apportionable tax base without including the subsidiaries' factors in the taxpayer's apportionment formula. Relying on this Court's decision in *Container* (595 A.2d at 1044-45) and on Justice Stevens' dissent in *Mobil* (*id.* at 1044 n.9), the Maine Supreme Court concluded that the "ineluctable result" of including the income derived from the taxpayer's unitary foreign subsidiaries' income in the apportionable tax base while excluding their factors from the formula "is that more of the business activity of the unitary business is attributed to Maine than is the actual case." *Id.* at 1044. The court concluded:

> Maine cannot, under the fairness principles of the due process clause requiring that the income it taxes be rationally related to values connected to the taxing

[13] When this Court denied certiorari in the Minnesota *NCR* case, the *Tambrands* case had not yet been decided.

> state, include in Tambrands' "apportionable tax base income from its . . . affiliates operating abroad . . . [and] apportion such income by factors reflecting only [Tambrands' domestic] operations." W. Hellerstein, *Dividing the State Corporate Income Tax Base: Developments in the Supreme Court and Congress*, appearing in *The State Corporation Income Tax* 293 (C. McLure, Jr. ed. 1984).

Id. (brackets in original).

In *American Tel. & Tel.*, the question was whether Wisconsin could constitutionally include dividend and interest income that the taxpayer received from its unitary subsidiaries in the taxpayer's apportionable tax base without including either the subsidiaries' property or, alternatively, the value of the taxpayer's investment in its subsidiaries, in the property factor of the taxpayer's apportionment formula. The Wisconsin Court of Appeals acknowledged that this Court had failed to address the merits of this issue in *Mobil* (143 Wis. 2d at 548, 422 N.W.2d at 635), but noted that commentators had recognized the force of the constitutional attack leveled at

> apportionment formulas which allegedly give insufficient weight to the sales, property and payroll of subsidiaries which make dividend, interest, royalty, and other payments to the parent corporation which are included in the taxing state as income subject to apportionment.

143 Wis. 2d at 549, 422 N.W.2d at 635. The court concluded that the inclusion in AT&T's apportionable tax base of dividends and interest it received from its unitary subsidiaries without adjustment of the apportionment formula's property factor to reflect the subsidiaries' contribution to the production of that income was constitutionally impermissible. "[T]he apportionment formula used by the department does not reflect a reasonable sense of how AT&T's income is generated and taxes value earned outside the borders of Wisconsin, contrary

to . . . the due process and commerce clauses of the United States Constitution." 143 Wis. 2d at 551, 422 N.W.2d at 636.

In *Homart*, the question was whether Rhode Island could include a nondomiciliary corporation's partnership income in the corporation's apportionable tax base without reflecting the partnerships' factors in the corporation's apportionment formula. In holding that "factor representation" was required, the Rhode Island Supreme Court declared:

> The inclusion of this income in Homart's net-income calculation for apportionment purposes necessarily requires that the payroll, property, and receipt factors that gave rise to it be included in the apportionment equation also. Otherwise, the net income is subject to an apportionment ratio that reflects only Homart's in-state and everywhere business activity when, in fact, this income did not arise from Homart's corporate business activity but instead arose out of the partnerships' business activities that were not reflected in the apportionment ratio.

Homart, 529 A.2d at 121.

Indeed, even those courts that have concluded, along with the court below, that "factor representation" is unnecessary in the absence of proof of "gross distortion," have recognized the unfairness of including income from unitary subsidiaries in the apportionable tax base without adjusting the apportionment formula to reflect the subsidiaries' income-producing activities. Thus the court below recognized that "South Carolina's taxing scheme is not ideally fair." App. D at 39a. *See also NCR Corp. v. Comptroller of the Treasury*, 313 Md. at 151, 544 A.2d at 780-81. In addition to the conflict that these decisions create with *Tambrands*, *American Tel. & Tel.*, and *Homart*, these courts' reliance on the good-enough-for-government-work defense that a theoretically defective apportionment can be justified as long as the resulting distortion is not too great raises a question that is it-

self worthy of this Court's review. *See, e.g., Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920) (apportionment formula may be struck down as "inherently arbitrary"); *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 133 (1931) (apportionment formula may be struck down as "intrinsically arbitrary").

The pernicious consequences of state courts' reliance on this lack-of-gross-distortion defense are aptly illustrated by this case. The court below explicitly recognized in *NCR I* that NCR's royalties and interest received from its foreign subsidiaries were earned—at least "[t]o a degree" (App. D at 39a)—in foreign countries. It further recognized that, as a result of South Carolina's failure to account for the foreign subsidiaries' factors in NCR's apportionment formula, South Carolina was taxing *on an annual basis* 28 percent more of NCR's income than it was entitled to if South Carolina's apportionment scheme had been "ideally fair." *Id.* at 38a; App. A at 6a.[14] Yet the court, with a perfunctory reference to this Court's decision in *Container*, dismissed this annual, systematic, and substantial overstatement of NCR's income as not amounting to a "gross disparity" (App. A at 7a) of "constitutional proportions." App. D at 40a.

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[14] The systematic overtaxation of NCR resulting from South Carolina's failure to permit "factor representation" is illustrated by NCR's 1981 tax year. By taking into account $32,996,316 of royalty income and $18,304,080 of interest income, the Commission increased apportionable income from $76,478,793 to $127,779,189, an increase of 67 percent. The only adjustment made by the Commission to the apportionment formula was to include the royalty and interest income in the denominator of the sales factor. Since the denominator of the sales factor was nearly $1.9 billion, this adjustment had the negligible effect of decreasing NCR's South Carolina apportionment percent by 0.4 percent. *See* Tr. of Record in *NCR I* at 196, 200. The inexorable consequence of increasing NCR's tax base by more than half, as a result of the inclusion of foreign source royalties and interest, without making a correlative adjustment to the apportionment formula was to permit South Carolina to tax substantial amounts of NCR's income that was earned outside the state.

Decisions in this case and others like it [15] represent a misapplication of this Court's state tax jurisprudence. They routinely cite *Container* for the proposition that the inexorable overtaxation that results from failure to provide "factor representation" is constitutionally "acceptable" (App. A at 6a) as long as it does not approach the 250 percent distortion found intolerable in *Hans Rees*. What these opinions fail to consider, however, is that the "substantial margin of error" standard articulated by *Container* (463 U.S. at 184) was designed to provide states with a constitutional cushion in implementing *theoretically sound* formulas that may on occasion produce results that fall short of perfection.[16] The standard was never designed as a safe harbor for analytically indefensible apportionment regimes like South Carolina's that produce systematic and substantial overtaxation of a corporation's income year after year.

When the South Carolina court's misuse of this Court's opinion in *Container* as a shield for a theoretically indefensible apportionment regime is considered in conjunction with the conflict that it creates with the decisions of other state courts, the need for this Court's guidance is clear.

III. THE ISSUES OF BOTH INTERNATIONAL MULTIPLE TAXATION AND "FACTOR REPRESENTATION" RAISED BY THE DECISION BELOW ARE RECURRING QUESTIONS OF GREAT PRACTICAL IMPORTANCE

Wholly apart from the incompatibility of the state court's decision with this Court's Foreign Commerce

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[15] *E.g., NCR Corp. v. Taxation and Revenue Dep't*; *Ashland Pipe Line*; *NCR Corp. v. Comptroller of the Treasury*.

[16] As noted above (*see supra* pp. 14-15), the apportionment formula at issue in *Container*, which included all of the income *and* all of the factors of the combined unitary group, was theoretically unobjectionable.

Clause precedents and from the conflict that the decision has created with other state courts of last resort, the decision below warrants this Court's review because it presents recurring questions of great practical importance.

The issues raised by this case arise in virtually every state with a corporate income tax. Like South Carolina, the overwhelming majority of states include intangible income that a corporate taxpayer receives from unitary foreign subsidiaries in the taxpayer's apportionable tax base.[17] Like South Carolina, the overwhelming majority of states fail to provide for "factor representation" when such income is included in a taxpayer's apportionable tax base. Indeed, NCR is aware of only two instances in which a state by statute provides for "factor representation" with respect to such income. N.H. Rev. Stat. Ann. § 77-A:3, II(b) (1991) ("factor representation" for dividends from unitary foreign affiliates); Utah Code Ann. § 59-7-303(4) (1992) (same). Consequently, the questions raised by the decision below—both with respect to international multiple taxation and with respect to "factor representation"—are constantly arising in almost every state with a corporate income tax. *See* Brief of *Amicus Curiae* Tax Executives Institute, Inc. in Support of Petitioner, *NCR Corp. v. Taxation and Revenue Dep't*, No.

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[17] The vast majority of states use federal taxable income as the starting point for calculating state taxable income. 1 Multistate Corporate Income Tax Guide (CCH) ¶ 125 (1993). The federal tax base generally includes dividends, interest, and royalties received from foreign affiliates. I.R.C. § 61. Accordingly, unless explicitly excluded, such foreign source income is includable in the apportionable tax base in most states. Although a number of states provide a complete deduction for dividends from foreign affiliates, most provide only a partial deduction or none at all. 1 Multistate Corporate Income Tax Guide (CCH) ¶ 79 (1993) (and paragraphs cited therein). Moreover, only a handful of states exclude foreign source interest or royalties from the state apportionable tax base. *See, e.g.*, Ohio Rev. Code Ann. § 5733.04(I)(2) (Anderson 1991); Va. Code Ann. §§ 58.1-302, 58.1-402(C)(8) (Michie 1991 & Supp. 1993).

93-541 (petition for certiorari pending); Brief of the Commission on State Taxation as *Amicus Curiae* in Support of Petitioner, *id.* These questions have resulted in widespread disputes between taxpayers and state taxing authorities, as illustrated by the cases already cited in this petition and many others that are currently pending in state courts and administrative tribunals.

The amount of taxes at stake in these controversies is enormous. Thousands of taxpayers annually receive billions of dollars in foreign source dividends, interest, and royalties,[18] and much of this income is includable in their state apportionable tax bases.[19] Indeed, NCR's foreign source royalties and interest constituted on average more than 39 percent of its South Carolina tax base. *See* App. E at 43a-44a; Tr. of Record in *NCR I* at 200-02. *See also Mobil*, 445 U.S. at 430 (involving "substantial amounts received as dividends from its subsidiaries and affiliates operating abroad"); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Finance*, 112 S. Ct. 2365 (1992) (involving over $10 million of dividends received from unitary foreign subsidiaries).

In view of the large number of taxpayers that are subject to taxing schemes like South Carolina's and the sig-

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[18] In 1986 alone, approximately $5.6 billion of dividends and $3.8 billion of interest, rents, and royalties were paid to large U.S. corporations (*i.e.*, those with total assets of at least $500 million) by their 7500 largest controlled foreign corporations. Internal Revenue Service, Statistics of Income Division, *Compendium of Studies of International Income and Taxes*, Pub. 1267 (9-91), 223. In 1988, 744 of these largest U.S. corporations filed information returns reflecting their holdings in controlled foreign corporations. Internal Revenue Service, *Statistics of Income Bulletin*, Vol. 12, No. 2 (Fall 1992), 71. When one takes account of smaller corporations, the total number of corporations receiving intangible income from foreign subsidiaries is obviously much larger.

[19] Although the foreign source income figures cited in note 18 *supra* include amounts paid by both unitary and nonunitary affiliates, plainly the amounts attributable to unitary subsidiaries are substantial.

nificant amounts of tax dollars involved, the practical importance of this controversy is self-evident.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted,

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Dated: March 9, 1994

APPENDIX A

THE STATE OF SOUTH CAROLINA
In the Supreme Court

NCR CORPORATION,
Appellant,

v.

SOUTH CAROLINA TAX COMMISSION,
Respondent.

Appeal From Richland County
Thomas L. Hughston, Jr., Judge

Opinion No. 23969
Heard November 17, 1993—Filed December 13, 1993

AFFIRMED

John C. von Lehe, Jr., and Stephen P. Groves, of Young, Clement, Rivers & Tisdale, of Charleston and William L. Goldman, of Lee, Toomey & Kent, of Washington, D.C., for appellant.

Chief Deputy Attorney General Ray N. Stevens, and Assistant Attorney General Sarah G. Major, both of Columbia, for respondent.

MOORE, A.J.: Appellant (NCR) commenced this action to recover $499,007 in corporate income tax and

license fees paid under protest for the years 1981-83. At issue is the apportionment formula used to determine how much of NCR's unitary business income is taxable in South Carolina. We affirm.

FACTS

NCR is a world-wide corporation with several foreign subsidiaries. Respondent (Tax Commission) determined NCR's total income to include royalties and interest income NCR received from its foreign subsidiaries. NCR objected to the inclusion of this income because Tax Commission did not factor into the apportionment formula the contribution of the foreign subsidiaries in generating that income. The trial court affirmed Tax Commission's ruling.

In *NCR Corporation v. South Carolina Tax Comm'n,* 304 S.C. 1, 402 S.E.2d 666 (1991) (*NCR I*), we remanded this case to the trial court with specific instructions to: (1) recompute NCR's taxable income by factoring into the apportionment formula the proportionate contribution by foreign subsidiaries in generating NCR's income; (2) determine NCR's tax liability accordingly; (3) compare this new calculation to the tax liability actually imposed. If there was a "gross disparity" between these two amounts, NCR would be entitled to a refund. The basis of this holding was that NCR's due process rights would be violated if the apportionment formula as applied resulted in a tax liability that was grossly disproportionate to the income generated in South Carolina.

On remand, the trial court recomputed NCR's tax liability, determined there was no gross disparity, and concluded NCR was not entitled to a refund. NCR again appeals.

ISSUES

1. Whether the trial court properly recomputed NCR's taxable income?

2. Whether the tax imposed is grossly disproportionate to the income attributable to South Carolina?

DISCUSSION

A.

Under S.C. Code Ann. §§ 12-7-1120 through -1170 (1976 and Supp. 1992), the applicable apportionment formula uses three factors: property, payroll, and sales. Each factor is reduced to a fraction by using as the numerator the amount of that factor attributable to South Carolina and using as the denominator NCR's total amount of that factor. The three factors are then averaged and the resulting fraction, expressed in a percentage, is multiplied by NCR's total business income to determine the amount of income apportioned to South Carolina for taxation. *See NCR I*, 304 S.C. at 4, 402 S.E.2d at 668.

In *NCR I*, we determined that the denominator of this fraction did not have to include the *total* sales, property, and payroll of NCR's foreign subsidiaries because subsidiaries and their corporate parents are separate entities. 304 S.C. at 6, 402 S.E.2d at 669. On remand, however, the trial court was directed to determine the *proportion* of sales, property, and payroll of foreign subsidiaries used to generate the royalties and interest paid to NCR.

The trial judge used a pro rata method to calculate the proportion of sales, property, and payroll of foreign subsidiaries to be included in the denominator of the apportionment formula. He took the amount of royalties and income interest paid by a foreign subsidiary to NCR, divided it by that subsidiary's total income, and multiplied the resulting fraction by the total sales, property, and payroll of the subsidiary. This proportion of each subsidiary's sales, property, and payroll was then added to the denominator of the apportionment formula and NCR's taxable income was determined accordingly.

NCR does not contest the basic method of calculation but challenges two steps in the computation. First, it contends a subsidiary's total income should exclude foreign taxes paid. Second, it contends the calculation should not be done separately for each subsidiary but rather the proportion of sales, property, and payroll should be calculated by adding the totals from all the subsidiaries together.

1. *Should a subsidiary's total income exclude foreign taxes paid?*

NCR contends that in computing the proportion of sales, property, and payroll of foreign subsidiaries to be included in the denominator of the apportionment formula, the subsidiary's net income should be reduced by the amount of foreign income tax paid. We disagree.

As Tax Commission correctly points out, S.C. Code Ann. § 12-7-700(4) (1976) does not allow a deduction to net income for income taxes paid when computing taxable income.[1] Since a foreign subsidiary's net income is determined with the ultimate goal of inserting it into the apportionment formula in order to compute NCR's taxable income, no deduction should be allowed for foreign income taxes paid by a subsidiary.

2. *Should the proportionate contribution of sales, property, and payroll of foreign subsidiaries be computed on a combined basis or individually?*

NCR contends the royalties and interest income paid by all of its forty-four foreign subsidiaries should be combined and then divided by the combined income of all the subsidiaries to determine the proportionate contribution of sales, property, and payroll by foreign subsidiaries. Using this method of calculation, the gains of various subsid-

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[1] This section was repealed for tax years after December 31, 1984. Thereafter, S.C. Code Ann. § 12-7-430(d)(1) (Supp. 1992) applies with the same result.

iaries would be offset by the losses of others. Tax Commission, on the other hand, contends the trial court correctly made the calculation separately for each subsidiary and added each separate amount to the denominator of the apportionment formula.

We find Tax Commission's method of calculation is the better approach since it is consistent with general tax principles. Subsidiaries are treated as separate entities for tax purposes. *NCR I.* Combining NCR's forty-four subsidiaries would in effect be treating them as if they exist only in relation to NCR. The trial judge correctly made the calculation for each subsidiary separately.

In conclusion, the trial judge properly calculated the proportion of sales, property, and payroll of foreign subsidiaries to be added to the denominator of the apportionment formula. Pursuant to our directive in *NCR I*, the question then becomes whether there is a gross disparity of constitutional proportion between the resulting tax liability calculated under the new formula and the tax liability actually imposed.

B.

In *NCR I*, NCR challenged the apportionment formula on the ground it violates due process because it results in an unfair apportionment of income to South Carolina.[2] This Court held NCR had the burden to show application of the apportionment formula has led to "a grossly distorted result." *NCR I*, 304 S.C. at 11, 402 S.E.2d at 672. In so holding, this Court relied on *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983), which upheld California's three-factor apportionment formula against a due process challenge.

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[2] In the framework of a due process analysis, this argument is considered a challenge to the "external consistency" of the apportionment formula. *See Container Corp., infra*, 103 S.Ct. at 2942.

The fact that application of an apportionment formula results in an imperfect measure of apportioned unitary income does not prove a violation of due process. *Amerada Hess Corp. v. Director, Division of Taxation*, 490 U.S. 66, 109 S.Ct. 1617, 1622, 104 L.Ed.2d 58 (1989). In *Container Corp.*, the United States Supreme Court found application of California's three-factor formula withstood a due process challenge because the margin of error was "within the substantial margin of error inherent in any method of attributing income among the components of a unitary business." 103 S.Ct. 2950. The Court noted application of the three-factor formula resulted in only a 14% increase in taxable income when compared to the accounting method espoused by the taxpayer and concluded the taxpayer had failed to meet its burden of showing a due process violation.

This Court followed the *Container Corp.* analysis as applied by the Maryland Court of Appeals in *NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 544 A.2d 764 (1988), and remanded this case for a determination of the amount of the disparity between the tax assessment calculated under the apportionment formula and the tax assessment calculated with the proportion of sales, property, and payroll of foreign subsidiaries factored into the denominator of the formula. The trial judge found an average difference of 27.9% for the three tax years in question. He concluded this margin of error indicated no gross disparity in NCR's apportioned income calculated under the apportionment formula and held there was no due process violation.

As already noted, the United States Supreme Court found the 14% margin of error in *Container Corp.* acceptable and specifically compared it to the 250% difference it found unacceptable in a due process challenge to a single-factor formula in *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 51 S.Ct. 385, 75 L.Ed. 879 (1931). Other state courts have upheld similar or

larger margins of error. *See Citizen's Utilities Co. v. Dept. of Revenue*, 94 Ill. Dec. 737, 111 Ill.2d 32, 488 N.E.2d 984 (1986) (213%); *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989) (23%). We find no gross disparity in this case and hold the apportionment formula as applied by Tax Commission results in no due process violation.

AFFIRMED.

HARWELL, C.J., CHANDLER, FINNEY and TOAL, JJ., concur.

APPENDIX B

STATE OF SOUTH CAROLINA)
)
COUNTY OF RICHLAND)

IN THE COURT OF COMMON PLEAS
FIFTH JUDICIAL CIRCUIT

Case No. 88-CP-40-1053

NCR CORPORATION,
Plaintiff,
-versus-
SOUTH CAROLINA TAX COMMISSION,
Defendant.

SUPPLEMENTAL ORDER ON REMAND

[Filed July 15, 1992]

This matter is before me based upon a Motion by the Plaintiff, NCR Corporation, to Alter or Amend Judgment. The Motion was timely filed following the issuance of an Order by me which was entitled the Order on Remand.

The purpose of the Motion to Alter or Amend Judgement was to invite this Court to consider an argument which NCR raised during the trial on remand of this case, but which NCR believes was not addressed by me in the Order on Remand.

There is disagreement among the parties concerning the meaning of the Motion and what argument NCR believes the Court did not address. The Tax Commission has interpreted NCR's Motion as presenting only the argument that any distortion regardless of size renders

the State's apportionment formula unconstitutional. NCR argues that the Tax Commission has mischaracterized its Motion. Based on the failure of the apportionment formula to take into account any of the payroll, property, or sales of NCR's foreign subsidiaries, and the resulting distortion (which I determined to be 27.9% for the three years in question), NCR states that it has "clearly placed before this Court its argument that the formula is inherently unfair, inevitably results in taxation of substantial extra-territorial values on an ongoing basis and that a conceptually flawed formula which would collect 27.9% too much tax every year, year after year, on a permanent ongoing basis is violative of the due process clause." (Plaintiff's Memorandum of Law, p. 2).

In order to avoid a dispute during the appeal of this case concerning the scope of NCR's Motion, I have considered all of the arguments presented by NCR. It is my opinion, after having examined all of these arguments, that the arguments are not persuasive of NCR's position that the State's apportionment formula is unconstitutional. It therefore remains the opinion of this Court that NCR is not entitled to a refund and that the assessment originally set by the Tax Commission is proper;

AND IT IS TO [SIC] ORDERED

/s/ Thomas L. Hughston, Jr.
THOMAS L. HUGHSTON, JR.
Presiding Judge
Fifth Judicial Circuit

Greenwood, South Carolina

Dated: July 11, 1992.

APPENDIX C

STATE OF SOUTH CAROLINA)
)
COUNTY OF RICHLAND)

IN THE COURT OF COMMON PLEAS

Case No. 88-CP-40-1053

NCR CORPORATION,
Plaintiff,

vs.

SOUTH CAROLINA TAX COMMISSION,
Defendant.

ORDER ON REMAND

[Filed November 26, 1991]

I. INTRODUCTION

On February 4, 1991, the South Carolina Supreme Court issued its Opinion in the case of *NCR Corporation v. South Carolina Tax Commission*, —— SC ——, 402 S.E.2d 666 (1991). There the court was confronted with a challenge to South Carolina's method of taxing royalty and interest income when such income was alleged by the taxpayer to have a foreign source. NCR challenged South Carolina's method by asserting that taxing such income violated the statutory requirements of South Carolina, the Foreign Commerce Clause requirements, and the Due Process Clause requirements. The Trial Court found no violations.

The Supreme Court affirmed the Trial Court in finding no violation of any South Carolina statute and in finding no violation of the Foreign Commerce Clause. The court, without intimating that the Trial Court's conclusion was in error, did believe, however, that the due process issue could best be examined by having the Trial Court further develop the issue. As a result, the Court directed the case be remanded to the Trial Court, and on April 22, 1991, Chief Justice Gregory vested jurisdiction in this court to hear the remand of this case.

II. ISSUE ON REMAND

A. *Background*

The due process challenge presented on remand concerns including in NCR's apportionment factors a portion of the payroll, property, and sales of NCR's royalty and interest paying subsidiaries. NCR asserts that its rights to due process are violated if South Carolina on one hand taxes NCR on the royalties and interest paid to it by its foreign subsidiaries while on the other hand, not including in its apportionment ratio the payroll, property, and sales of the subsidiaries that paid the income. When such issue was presented to this Trial Court during the initial trial of this matter, NCR asserted that to satisfy due process, 100% of the subsidiaries' payroll, property, and sales was required to be added to its apportionment ratio. The Tax Commission asserted that due process was satisfied without including any of the subsidiaries' payroll, property, and sales in NCR's factors since South Carolina was not taxing any of the subsidiaries' income. Rather, South Carolina was taxing only the income of the parent (NCR) and all of NCR's payroll, property, and sales were included in the apportionment factors.

Thus, the two sides in the initial trial of this case were on opposite extremes with NCR arguing that due process demanded the inclusion of 100% of the subsidiaries' pay-

roll, property, and sales, while the Tax Commission asserted none was to be included. Such conflicting views set the background for the issue now on remand.

B. *Due Process and Factor Relief*

The Supreme Court examined the due process issue and for purposes of the remand, gave the parties and this Court guidance in two areas. The first dealt with the burden of proof and the second with the method for the Trial Court to use in testing the formula in light of the Due Process requirements.

1. *Burden of Proof*

The burden of proving that the formula violates due process is on the taxpayer.

> At bottom, in order to prove a violation of due process, a taxpayer must clearly and cogently prove the apportionment formula, as applied, "has led to a grossly distorted result" or that "the income attributed to the state is in fact out of all proportion to the business transacted . . . in that State." (cite omitted)

NCR v. South Carolina Tax Commission, supra, at p. 672.

The court found that it was unable to determine from the record whether the exclusion of the subsidiaries' payroll, property, and sales from NCR's factors resulted in the taxing of an amount of income which was disproportionate to the business transacted in South Carolina. Because it was unable to determine the degree, if any, of disproportionality, the Court gave specific guidelines to be followed on remand to address this issue.

2. *Statement Of Trial Court's Duties*

In conducting the remand, the Court identified the tasks for the Trial Court to accomplish.

> . . . we remand this case to the lower court for a re-factoring of the formula, considering in the formula denominator the proportionate measure (as determined by the trial court led by the broad guidelines set out in this opinion) of the foreign subsidiaries' property, payroll, and sales which generated the NCR income. Once this is done, the new tax amount should be figured and compared with the tax amount presently assessed against NCR by the Tax Commission. If the trial court finds there is a gross disparity between the two amounts of constitutional proportions, it shall order the new tax amount to be assessed and refund granted. If no gross distortion exists upon a comparison of the tax amounts, the original tax assessed against NCR shall stand and NCR shall not be entitled to any refund.

NCR v. South Carolina Tax Commission, supra, at p. 674.

This language essentially assigns four tasks to this court. First, re-factor the formula; second, compute the new tax; third, compare the new tax to the old tax; and finally, decide if a gross disparity "of constitutional proportions" exists between the new tax and the old tax.

C. *Performing The Trial Court's Duties*

1. *Re-factoring the Formula*

Re-factoring the formula is accomplished by adding to NCR's factors that portion ". . . of the foreign subsidiaries' property, payroll, and sales which generated the NCR [royalty and interest] income." The parties have approached this requirement in different fashions. NCR has employed two methods (the Intangible Method and the Pro Rata Method) while the Tax Commission has presented one approach (the Pro Rata Method). This court finds that the Intangible Method is an inappropriate method for accomplishing the re-factoring but that the

Pro Rata Method is, when properly applied, a suitable choice.

a. *The Intangible Method Is Improper*

The Intangible Method advanced by NCR seeks to establish that the royalty and interest income can be directly traced as being earned by the payroll, property and sales of each subsidiary that produced that income. The court finds this is a faulty premise.

The idea that one can trace the royalty and interest income to the subsidiaries' payroll, property and sales must be based on the view that in some fashion these factors actually produced the royalty and interest income. This court finds that view unrealistic. In fact, NCR itself did not suggest a tracing method for connecting the payroll of a subsidiary to the royalty or interest produced by that subsidiary. Rather, to compensate for this lack of tracing, NCR used the Pro Rata Method to determine the amount of the subsidiaries' payroll to be added to NCR's payroll. Thus, as to the payroll factor NCR does not use a tracing method at all but rather employs the Pro Rata Method.

Further, the tracing method used by NCR for the property factor is improper under our existing statutes and produces an anomaly. NCR's "tracing" method increased the property factor of NCR by adding the intangibles that produced the royalty income (i.e. the investments in the trademarks and patents) and the intangibles that produced interest income (i.e. the investments in the notes). Such is specifically prohibited by S.C. Code Ann. § 12-7-1150 (1976) since the property factor by statute consists of only tangible property. The method suggested by NCR creates an anomaly in that NCR itself is forbidden by § 12-7-1150 (1976) from adding its intangible property to its own factors and yet the method suggested by NCR allows NCR to do precisely what the statute forbids. This court cannot adopt such a view. Rather,

the court finds the pro rata method more accurately accomplishes the required re-factoring.

b. *The Pro Rata Method Is Proper*

Both parties have employed a pro rata approach. The pro rata approach is based on determining the ratio of the total royalties and interest generated by the subsidiaries to the total of all incomes produced by the subsidiary. In other words, the royalty income plus interest income over the total of all incomes produced by the subsidiaries with such incomes consisting of the royalty income paid to NCR, the interest income paid to NCR and the subsidiaries' own net income. The ratio is then converted to a percentage that is multiplied by the payroll, property and sales of the subsidiary. This computation yields an additional amount of payroll, property and sales that is added to NCR's factors. Under this method, a portion of the subsidiaries' factors is included in NCR's factors.

Having found the Pro Rata Method is a reasonable method of re-factoring, the court further finds from the evidence and testimony that the approach employed by the Tax Commission is more appropriate to accomplishing the re-factoring than is the pro rata approach suggested by NCR. Each approach is discussed in this Order.

c. *Application Of The Pro Rata Method*

The court agrees with the Tax Commission that the subsidiaries generate three categories of income relevant to this dispute: interest income to NCR, royalty income to NCR, and finally, the net income of the subsidiaries themselves. The interest income and the royalty income here in dispute are income of NCR which is taxable by South Carolina while the net income of the subsidiaries is not taxable by South Carolina. The property, payroll and sales factors apparently were used to generate all three classes of income. Thus the re-factoring should only increase NCR's factors by that percentage of the

subsidiaries' factors that produce the income taxable by South Carolina. In short, the portion of the subsidiaries' factors that produced its own non-taxable net income should not be added to NCR's factors.

To decide what percentage of the factors generates the interest and royalty income which is taxed by South Carolina, a computation must be made. First, a fraction is created with the total income (royalty income plus interest income plus subsidiaries' net income) being the denominator and royalty income plus interest income being the numerator. Under this approach, a computation is made in which the percentage given by this fraction is multiplied by the payroll, property, and sales of the subsidiaries. The resulting amounts of payroll, property and sales are then added to NCR's factors to arrive at the re-factored payroll, property and sales used to generate the income taxed by South Carolina.

Under this approach, the denominators of the payroll, property, and sales ratios of NCR, the parent, are increased by adding to such denominators the appropriate percentages of each of the subsidiaries' payroll, property, and sales. When this is done, the ratio is re-factored, consistent with the Supreme Court's instructions, by using the proportionate share of the subsidiaries' payroll, property, and sales which generated the royalty and interest income. In applying the Pro Rata Method, NCR differed in two respects from the method being applied by this court. First, NCR seeks to reduce the net income of the subsidiaries by the foreign income tax paid. Second, NCR makes its computation of net earnings by combining all of the subsidiaries into one net earnings amount, while the court calculates each subsidiary's net earnings separately. The Court finds NCR's approach is in error and such is addressed here.

i. No Deduction Is Permitted For Foreign Income Taxes Paid

In order to determine what percentage of the subsidiaries' payroll, property, and sales generated the royalty and interest income here in dispute, the total of all income produced by those factors must be computed. Other than the royalty and interest income, the subsidiary produced its own net income as well. Thus, to compute the total income produced, it is necessary to determine the net income of the subsidiary.

NCR believes that foreign income taxes paid are deducted from the net income of the subsidiaries. This court finds that NCR's method of reducing the subsidiaries net income by the foreign income taxes is in error.

It must be remembered that the dispute arose in this action based on NCR's view that it was unfair to tax all of the foreign royalties and interest unless all of the payroll, property, and sales of the subsidiaries were included in NCR's factors. This court held in its previous order that including all of the subsidiaries' factors was incorrect since South Carolina did not tax any of the subsidiaries' net income, and therefore, it would be improper to include factors from entities over which South Carolina had no ability to tax.

Such a view is especially proper when re-factoring since the purpose of the re-factoring is to determine what portion of the subsidiaries' factors generated South Carolina taxable income. Consistent with that view, this court holds that it is improper to include in the re-factoring any portion of the subsidiaries' factors that generates net income that South Carolina is unable to tax. Thus to determine the correct amount of income for purposes of the re-factoring computation, the net income of the subsidiaries must be the taxable net income that South Carolina is unable to tax.

Further, not to use taxable net income would be improper since the computation would then be based on

combining inconsistent items. On one hand, the royalty and interest income amounts are taxable income, but the net income figures suggested by NCR would not be. NCR's approach does not arrive at income subject to tax and thus must be rejected.

In determining income subject to tax, South Carolina does not allow a deduction for foreign income taxes paid. (See S.C. Code Ann. § 12-7-700(4) (1976) denying a deduction for taxes on income, measured by income, or with respect to income; also see S.C. Code Ann. § 12-7-430(d)(1) (Supp. 1990) denying deductions for income taxes or any taxes measured by or with respect to net income.) Accordingly, in determining the income generated by the subsidiaries, no deduction is allowed for foreign income taxes paid. Thus, NCR's method not only adds numbers which are incompatible in that some are taxable income figures while others are not, but also NCR's method uses net income after deducting taxes. NCR's approach is closer to the subsidiaries' financial accounting income which obviously is not controlling for tax purposes.

ii. The Subsidiaries Must Be Treated Separately Rather Than As A Single Unit

NCR also combines all of the subsidiaries into a single unit for purposes of the re-factoring computation. Such a procedure is improper. The question on remand is what percentage of the payroll, property, and sales of each royalty and interest paying subsidiary is to be added to the factors of NCR. There are numerous subsidiaries paying royalties and interest, and each is a separate corporate entity generating its own income and its own expenses. In fact, the corporations are generally associated with a specific country and, while there are some transactions between subsidiaries, the dealings between corporations are inconsequential for purposes of this action.

In light of these findings, the court holds that it is improper to compute the net income of the subsidiaries

as one combined total. To do so allows the loss of one subsidiary to be applied to the positive net income of a separate subsidiary. For example, in 1981, the subsidiary in Argentina had a loss of $42,058,112. This loss is available, under NCR's approach, as an offset to the positive net income of numerous corporations without sufficient basis justifying the offset. For example, such loss as used by NCR has the effect of offsetting the positive net income of such distinctly profitable corporations as are listed below:

Australia	$ 4,843,521
Belgium	3,339,646
Iraq	110,596
Mexico	5,061,080
New Zealand	785,739
Puerto Rico	751,779
Switzerland	16,978,269
United Kingdom	9,035,302
Zwimbabwe [sic]	1,151,845

The process of using the losses from some subsidiaries to offset the income of profitable subsidiaries under NCR's approach results in a "combined" profit of all subsidiaries for 1981 of only $10,541,743. Such is an inaccurate representation of the actual business of each corporation.

The court finds that the net income of each subsidiary should be computed separately. Thus, each subsidiary has an amount shown for royalty income produced, interest income produced, and for that subsidiary's net income produced. Once these three amounts are totalled, the percentage of the total represented by the royalty and interest income is computed. This percentage is then used to determine how much of that subsidiary's factors are to be added to NCR's factors. This method is the manner in which the Tax Commission has applied the Pro Rata Method.

It is the conclusion of this court that the Tax Commission's approach is the correct one. Such approach

does not distort the net income of the subsidiaries by artificially shifting losses from one subsidiary to another. Further, and as explained above, the Tax Commission's method correctly denies a reduction of the subsidiaries' net income for foreign income taxes in determining the total amount supported by the payroll, property and sales of the subsidiaries.

Based on the Tax Commission's method, which this court approves, the following amounts are added to NCR's factors:

	1981	1982	1983
Property	$668,318,293	$388,123,864	$420,567,133
Payroll	252,669,129	127,076,814	144,031,029
Sales	831,120,410	567,809,097	657,656,007

By adding the above amounts to NCR's factors, the requirement of the Supreme Court to re-factor the ratio used by NCR is met. Such being accomplished, it is now this court's duty to compute the new tax resulting from the re-factoring.

2. *Computation Of The New Tax*

After re-factoring the ratios of NCR, as is done above, this court is required to compute the new tax based on the new ratios. The evidence shows that the new tax amounts, including the re-factoring, are as follows:

	1981	1982	1983
New tax	$138,001	$216,977	$344,948

3. *Compare Old Tax To New Tax*

The third task of this court is to determine the difference which results from comparing the old tax (the tax asserted by the Tax Commission in its assessment in which no provision is allowed for any of the payroll, property, or sales of the subsidiaries) to the new tax (the tax computed by using the new ratios generated by the re-factoring). The table below shows this comparison.

	1981	1982	1983
Old tax	$190,879	$264,541	$426,600
New tax	−138,001	−216,977	−344,948
Difference	52,878	47,564	81,652

Based on these computations, the act of not including a proportionate share of the payroll, property, and sales of the subsidiaries results in an increase in tax due by a taxpayer. That increase as a percentage of the new tax (i.e. including the re-factoring amounts) results in an increase in tax liability of the following percentages for each of the tax years here in dispute:

	1981	1982	1983
Difference	$ 52,878	$ 47,564	$ 81,652
New Tax	138,001	216,977	344,948
% of Increase	38.3%	21.9%	23.6%
Average Increase	27.9%		

The above computation identifies that for the years involved there was an average increase in tax of 28% due to not allowing NCR to employ any of the factors of the subsidiaries. Based on this percentage, this court is asked to examine on remand whether such an amount is a constitutional violation. This court finds there is no constitutional violation and this aspect is discussed below.

4. No Gross Disparity Is Present

The final task for this court is to decide if the difference between the original tax and the new tax constitutes ". . . a gross disparity between the two amounts of constitutional proportions." This gross disparity test is part of the fairness requirements of due process. Before examining the evidence concerning a "gross disparity" in the instant case, it is important to understand the background surrounding the proof necessary to establish the existence of a gross disparity.

The Due Process Clause requires satisfying a test commonly referred to as the external consistency test. This

test seeks to show that the apportionment factors "reflect a *reasonable* sense of how income is generated." (Emphasis added) *Container Corp.*, 463 U.S. at p. 169. In this formulation of the test, the Court underscores the view that the factors in the formula are only to be reasonable. Exactness is not a requirement and is not possible. In fact, to develop the view that rough approximations are valid, the *Container* Court identified the "gross disparity" test to set the outer limits of what is reasonable. 103 S.Ct. at p. 2942:

> . . . we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is, in fact, 'out of all appropriate proportions to the business transacted . . . in that State,' [*Hans Rees' Sons, Inc.*] 283 U.S. at 135, 51 S.Ct. at 389, or has 'led to a grossly distorted result,' [*Norfolk & Western R. Co. v. State Tax Comm'n.*, 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)]." *Moorman Mfg. Co.*, supra, 437 U.S. at 274, 98 S.Ct. at 2345.

Our Supreme Court recognized that the factors are not required to be exact, but rather, are only required to be reasonable. In *Covington Fabrics v. South Carolina Tax Com'n.*, 264 S.C. 59, 212 S.E.2d 574, 577 (1975), the Court stated the following:

> Although exactness in apportionment is desirable, all that is required is a reasonable approximation.

A taxpayer, to show the existence of a gross disparity, must conclusively demonstrate that South Carolina's apportionment formula is unfair in due process terms. That this task, imposed on a taxpayer, carries a heavy and difficult burden of proof is fully supported by the United States Supreme Court in *Container,* supra.

> We turn now to the question of fair apportionment. Once again, appellant has the burden of proof; it

> must demonstrate that there is "no rational relationship between the income attributed to the State and the intrastate values of the enterprise," Exxon Corp., 447 U.S. at 220, 100 S.Ct. at 2118, quoting Mobil, supra, 445 U.S. at 437, 100 S.Ct. at 1231, by proving that the income apportioned to California under the statute is "out of all appropriate proportion to the business transacted by the appellant in that State," Hans Rees' Sons, Inc., 283 U.S. at 135, 51 S.Ct. at 389.

Container Corp., supra, 103 S.Ct. at p. 2948.

Thus, *Container*, supra, states that an apportionment method can be held improper only if the taxpayer demonstrates by clear and cogent evidence that the income attributed to the State is out of all appropriate proportions to the business transacted there or the formula leads to a grossly distorted result. It is this court's view that in the instant case South Carolina's formula does not lead to a grossly distorted result. In fact, this court finds that the re-factoring computation proves there is no gross distortion.

Gross distortion of a constitutional magnitude has been rare and the United States Supreme Court has been reluctant to conclude a formula created a gross distortion. In *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), a three-factor formula apparently caused a 1500% increase in tax compared to the tax under the taxpayer's view. Despite this, the Court found the formula proper. It is significant to note that the United States Supreme Court has stricken only one apportionment formula because of distortion. In *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931), a 250% distortion created by a single-factor formula was held improper. Such a result is far removed from the instant case since here the well established three-factor formula is used by South Carolina and equally as significant is this court's

finding that on average there is an increase in tax of only 28%.

Other state courts have refused to strike down the three-factor formula in the face of alleged gross distortions. In Illinois in *Citizen's Utilities Co. of Illinois v. Dept. of Revenue,* 488 N.E.2d 984 (1986), an apparent 213% increase was not fatal. In *Westinghouse Electric Corp. v. Com. of Rev.,* 398 N.W.2d 530 (1986), the Minnesota court upheld the three-factor formula despite an alleged increase in tax of 300%.

It must be noted that even under the evidence produced by NCR and even assuming that NCR's methodology is correct (which this court has found to be incorrect) there is still no constitutional violation. NCR sought to establish that its highest percentage of distortion was 73% in 1981 and the average for the three years was 51%. Under the criteria of NCR having the burden of showing a "gross distortion" it is this court's conclusion that such has not been established.

The three-factor formula is always an approximation and cannot be overturned unless the evidence clearly shows that the state has taxed an amount beyond all reasonable relationship to the activities of the taxpayer in the taxing state. Here the source of the royalty and interest income cannot be placed as having been earned in any designated location. Rather, the activity of NCR is that of a unitary business and the source or location of any of its income simply cannot be determined. That is in fact the very reason the three-factor formula is appropriate and it is this court's view that the formula is within the constitutional limitations of Due Process.

III. CONCLUSION

Accordingly, this court finds that after re-factoring the apportionment formula, South Carolina has not taxed the income of NCR beyond the limits set by the Due

Process Clause of the Constitution. It is the order of this court that NCR is not entitled to a refund and that the assessment originally set by the Tax Commission is proper.

AND IT IS SO ORDERED.

/s/ Thomas L. Hughston, Jr.
THOMAS L. HUGHSTON, JR.
Presiding Judge
Fifth Judicial Circuit

Nov. 26, 1991.

APPENDIX D

STATE OF SOUTH CAROLINA
In The Supreme Court

NCR CORPORATION,
Appellant,

v.

SOUTH CAROLINA TAX COMMISSION,
Respondent.

Appeal from Richland County
Thomas L. Hughston, Jr., Judge

Opinion No. 23328

Heard October 23, 1990—Filed February 4, 1991

AFFIRMED IN PART AND REMANDED

John C. von Lehe, Jr. and Stephen P. Groves, both of Charleston; and William L. Goldman, of Lee, Toomey & Kent, of Washington, D.C., for appellant.

Deputy Attorney General Ray N. Stevens, of the South Carolina Tax Commission, of Columbia, for respondent.

TOAL, A.J.: This appeal involves an attempt by NCR Corporation ("NCR") to recover certain corporate income taxes and license fees paid under protest to the South Carolina Tax Commission ("Tax Commission"). The trial judge ruled that no refund should be given NCR. We affirm in part and remand.

FACTS

NCR is a multinational corporation engaged in the business of developing, manufacturing, marketing, installing, and servicing business information processing systems. All phases of NCR's businesses are conducted partly within and partly without South Carolina. In foreign countries, NCR conducts its business both directly through branch offices and through subsidiary corporations. During the years at issue (the 1981-1983 tax years) there existed approximately eighteen foreign branches and seventy-five foreign subsidiaries doing business in approximately one hundred fifty-nine countries. The foreign subsidiaries are owned 100% by NCR, with the exception of NCR's subsidiary in Japan, in which NCR has 70% ownership. These subsidiary companies have not conducted any business within South Carolina.

In conducting this worldwide business, NCR develops, acquires, owns, and uses patents and patent rights, both in the United States and in foreign countries. Also, NCR registers patents and licensing agreements in foreign countries pursuant to which NCR's foreign subsidiaries have the right to manufacture and sell business machines and equipment in those countries. These patent licensing agreements generate royalty income to NCR from the foreign subsidiaries. Further, NCR registers certain foreign loan agreements in foreign countries. It therefore receives interest income from the various loans it makes to the foreign subsidiaries. NCR also receives interest income from deposits it makes in foreign countries.

This royalty and interest income is itemized in NCR's federal income tax return as royalty and interest income earned in these foreign countries. Foreign countries in which NCR and its subsidiaries do business tax the net income of the subsidiaries. In addition, many of the countries impose an unapportioned tax on NCR on the full value of all royalty and interest amounts earned by NCR and paid to it by its foreign subsidiaries. A fed-

eral tax credit is granted to NCR for the royalty and interest income taxes paid to foreign governments.

The royalty income of NCR here in dispute is as follows:

1981	1982	1983
$32,996,316	$39,242,371	$49,992,119

The interest income of NCR here in dispute is:

1981	1982	1983
$18,304,080	$23,924,409	$16,562,396

South Carolina's corporate income tax is an apportioned income tax, through which South Carolina attempts to tax NCR's unitary business [1] income on roughly a percentage basis which is derived by comparing NCR's South Carolina business to the rest of its business. NCR's corporate income tax liability in South Carolina is determined by using a three-factor apportionment formula.[2] The factors are sales, property, and payroll. Each "factor" is reduced to a fraction. The numerator of the sales factor, for example, is the amount of NCR's South Carolina sales; the denominator of the sales factor is the amount of NCR's South Carolina sales combined with all other sales. The property and payroll factors are computed in the same manner. The three factors are averaged and the resulting fraction, expressed in a percentage, is multiplied by NCR's total business income. The resulting dollar amount is the business income properly apportioned to this state for taxation. The tax is then levied on this apportioned income. *See generally, Emerson Elec. Co. v. Wasson*, 287 S.C. 394, 339 S.E.2d 118 (1986).

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[1] All parties concede that NCR is engaged in an integrated unitary business nationwide and worldwide.

[2] *See* S.C. Code Ann. §§ 12-7-1120 - 12-7-1170 (1976 and Supp. 1989).

Here, the Tax Commission included in NCR's total income for tax purposes the royalty and interest income it received from its foreign subsidiaries. The Tax Commission did not include in its apportionment equation any of the foreign subsidiaries' sales, property or payroll. NCR argues that South Carolina may not tax it in this manner, since such a tax: (1) is contrary to statutory mandates; (2) violates the foreign commerce clause of the United States Constitution; and (3) violates the due process clause of the United States Constitution. NCR therefore seeks $499,007 by way of a refund of taxes paid under protest.

LAW/ANALYSIS

I. STATUTORY CONSTRUCTION

NCR contends we should interpret our statutory apportionment taxing scheme as requiring that foreign subsidiaries' payroll, property, and sales be included in the denominator of South Carolina's apportionment formula. NCR cites, by way of example, § 12-7-1150 (1989 Supp.), which contains the procedure to be used for determining the "property" factor. This statutory section provides, in pertinent part, for a:

> ratio of the average value of the real estate and tangible personal property, as defined in this section, used by such taxpayer in this State during the income year, to the average value of the entire real estate and tangible personal property, as defined in this section, used by the taxpayer *everywhere* during the income year . . . ." (emphasis added).

Similar verbiage is used in the statutory sections dealing with the sales and payroll factors. NCR points to the language such as "everywhere" in § 12-7-1150 and argues that its plain meaning mandates an inclusion of the foreign subsidiaries' sales, property, and payroll in the denominator of the fraction used to determine apportioned income.

It appears only one court has agreed with NCR's position in this regard. *See Kellogg Co. v. Herrington*, 216 Neb. 138, 343 N.W.2d 326 (1984). The *Kellogg* Court purported to apply statutory construction rules, including the "plain meaning" rule, in reaching the result NCR urges here. *Kellogg* has been criticized heavily as "mindless", and as "heedless" of clear legislative intent. *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989); *NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 544 A.2d 764 (Ct. App. 1988).

Although the statutes indeed do include words aiding NCR's urged interpretation, those words must be read in context. Each of the statutory sections defining the ratios of property, payroll, and sales use the singular word "taxpayer". In *Emerson Elec. Co. v. Wasson*, 287 S.C. 394, 339 S.E.2d 118 (1986), we held parent and subsidiary corporations are not to be considered a single entity for purposes of § 12-7-1170. South Carolina is not taxing the income of NCR's subsidiaries, but instead only the income of NCR itself as a separate corporate entity. Consequently, subsidiary payroll, sales, and property also should generally not be considered under our statutory scheme.

We follow the holding of the Maryland Court in *NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 544 A.2d 764, 777-78 (Ct. App. 1988), in which the court stated:

> it is the taxpayer's property, sales, and payroll values, in Maryland and in total or everywhere, that enter the formula. "The taxpayer" does not, of course, include the taxpayer's subsidiaries or their property, sales and payroll values, just as the subsidiaries' income is not included . . . .

We also rely upon the Minnesota Supreme Court's ruling in *NCR Corp. v. Commissioner of Revenue*, 438 N.W. 2d 86 (Minn. 1989), in which the Court held:

> Because NCR is the only "taxpayer" involved in this case, the apportionment statute contemplates that only its factors of property used, payroll paid, and sales made are relevant for inclusion in the denominator of the apportionment function. Therefore, NCR's construction argument must be rejected.

We likewise reject NCR's argument in this regard.

II. FOREIGN COMMERCE CLAUSE

NCR next argues that, since foreign countries have taxed the royalty and interest amounts in full, South Carolina may not do so since such would amount to a violation of the foreign commerce clause. The foreign commerce clause provides: "Congress shall have power . . . to regulate commerce with foreign nations, and among the several states, and with the Indian tribes." U.S. CONST. Art. I, § 8, cl. 3. NCR maintains the United States Supreme Court decision in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 99 S.Ct. 1813, 60 L.Ed.2d 336 (1979) requires reversal of the trial court.

Japan Line dealt with an attempt by California to impose an *ad valorem* property tax on cargo containers, owed by Japanese companies, which were instrumentalities of foreign commerce and which were temporarily located in various California ports while *en route* to other destinations. The same containers were also subject to an unapportioned property tax in Japan. The *Japan Line* Court first set forth the test used in determining whether an impermissible burden on interstate commerce had resulted from the state tax, and established that test as a threshold challenge to be met by the state in foreign commerce clause tax cases. The Court stated: "[i]f the State tax 'is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State, no impermis-

sible burden on interstate commerce will be found." *Japan Line*, 441 U.S. at 444-45, 99 S.Ct. at 1819 (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326 (1977)).

The *Japan Line* Court next established that:

> An inquiry more elaborate than that mandated by *Complete Auto* is necessary when a state seeks to tax the instrumentalities of foreign, rather than of interstate, commerce. In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If a State tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.

441 U.S. at 451, 99 S.Ct. at 1823. The Court proceeded to employ those two additional tests, and found that the California tax contravened both "precepts". Specifically, the Court found that California's tax in fact caused a "double tax"; and that a treaty entitled the "Customs Convention on Containers" existed between the United States and Japan, which stated that containers used exclusively in foreign commerce and "temporarily imported are admitted free of 'all duties and taxes whatsoever chargeable by reason of importation.'" 441 U.S. at 453, 99 S.Ct. at 1824 (quoting from 20 U.S.T. at 304). Hence, the Court reasoned, the actual double tax present violated prong one of the foreign commerce clause test, and the state tax in the face of the treaty contravened prong two—that the Federal Government must be able to speak with one voice.

Read in isolation, *Japan Line* appears to support NCR's position here. However, the case controlling the

situation here is not *Japan Line* in our view, but *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983). In *Container Corp.* the Court retreated from its broad *Japan Line* rules and in our view restricted *Japan Line* substantially. *Container Corp.* again involved a California tax. This time, however, the tax was an apportioned corporate income tax on Container Corporation, a company headquartered in Illinois but doing business in California as well as other states and countries. California imposed the same three-factor apportionment formula upon Container corporation as was here imposed by the Tax Commission on NCR.

The *Container Corp.* Court first addressed this formula method of taxation thusly:

> Under both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, "tax value earned outside its borders." In the case of a more-or-less integrated business enterprise operating in more than one State, however, arriving at precise territorial allocations of "value" is often an elusive goal, both in theory and in practice. For this reason and others, we have long held that the Constitution imposes no single formula on the states, and that the taxpayer has the "distinct burden of showing by 'clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed. . . ."
>
> . . . .
>
> The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing

> jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction. This Court long ago upheld the constitutionality [of this] method. . . .

463 U.S. at 164-65, 103 S.Ct. at 2939-40. (citations omitted). The Court went on to state that the three-factor formula used by California (and South Carolina here) not only met its approval but was "something of a benchmark against which other apportionment formulas are judged." 463 U.S. at 170, 103 S.Ct. at 2943.

In *Container Corp.*, California required Container Corporation, against its will, to include all foreign subsidiary income as part of its "unitary" business, and at the same time included in its calculations the foreign subsidiaries' property, payroll, and taxes. Container Corporation complained that the inclusion of the foreign subsidiary income in California's apportionment tax scheme violated the *Japan Line* case, since the foreign countries had already taxed the same income on an unapportioned basis.[3]

On this point the Court retreated from its *Japan Line* test. The Court first stated:

> [t]his case is similar to *Japan Line* in a number of important respects. First, the tax imposed here, like the tax imposed in *Japan Line*, has resulted in actual

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[3] The taxing scheme employed by the Tax Commission here differs from California's. California ignored corporate identities and included all foreign subsidiary income and all foreign subsidiary property, payroll, and taxes in its apportionment formula. South Carolina uses the "separate entity" method, in which corporate divisions are recognized. Either method is permissible as a general matter. *See Container Corp., supra*, 463 U.S. at 167-168, 103 S.Ct. at 2933. *Container Corp.* rejected the foreign commerce clause complaint of multiple taxation where the California method of ignoring corporate identities was involved; we reject the same argument here, where the separate entity method is used.

> double taxation, in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part.

Container Corp., 463 U.S. at 187, 103 S.Ct. at 2951-52. However, where actual double taxation appeared to end the inquiry in *Japan Line*, the *Container Corp.* Court stated "[n]evertheless, there are also a number of ways in which this case is clearly distinguishable from *Japan Line*." 463 U.S. at 187-88, 103 S.Ct. at 2952. The Court observed that the *Container Corp.* decision was distinguishable since: (1) the tax is on income rather than property; (2) the double taxation, although real, is not "inevitable" under the California taxing scheme; and (3) the tax falls on a domestic corporation, not a foreign owner of an instrumentality of foreign commerce.

The same distinguishing factors exist which make *Japan Line* inapplicable in the instant case. This is not a property tax case. We are unconvinced that double taxation is "inevitable" under the South Carolina taxing scheme. *See NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989) (holding the Minnesota separate entity taxing scheme employed there in an identical situation as here did not result in inevitable double taxation).[4] Further, the tax here falls on a domestic corporation, not a foreign company as in *Japan Line*.

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[4] Even if we were convinced the tax resulted in inevitable double taxation, we doubt, in light of the other facts clearly distinguishing this case from *Japan Line*, that the taxing scheme should be struck down. Indeed, the *Container Corp.* Court observed, "we specifically left open in *Japan Line* the application of that case to 'domestically owned instrumentalities engaged in foreign commerce' . . . and—to the extent that corporations can be analogized to cargo containers in the first place—this case clearly falls within that reservation." 463 U.S. at 188-89, 103 S.Ct. at 2952.

As to the second prong of *Japan Line*—that a state taxing scheme should not prevent the Federal Government from speaking with one voice—the test is "whether a state tax implicates foreign policy issues or violates a clear federal directive." *NCR Corp. v. Commissioner of Revenue, supra,* 438 N.W.2d at 94-95 (citing *Container Corp.,* 463 U.S. at 194, 103 S.Ct. at 2955). We reject NCR's contention that this prong of *Japan Line* is violated, as we perceive no clear Federal directive precluding the South Carolina Tax Commission's actions. "Whether any alleged increased tax liability affects federal foreign policy is, as observed by the Supreme Court of the United States, more appropriately addressed by other branches of the government." *NCR Corp. v. Commissioner of Revenue, supra,* 438 N.W.2d at 95.[5]

Thus, we reject NCR's foreign commerce clause argument, and hold that the method of taxation employed by the Tax Commission passes all constitutional tests in that regard. We next address NCR's due process contention.

III. DUE PROCESS

It cannot be doubted that "fairness is the test of due process constitutionality in the context of unitary business income taxation." *NCR Corp. v. Comptroller of the Treasury,* 313 Md. 118, 544 A.2d 764, 779 (Ct. App. 1988).

> [A]n apportionment formula must, under both the Due Process and Commerce Clauses, be fair . . . . The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult

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[5] We note that no treaty similar to that in *Japan Line* exists here which by its text prevents state taxation of NCR's foreign subsidiary royalty and interest income.

> requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not "invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing state. . . ."

Container Corp., 463 U.S. at 169-170, 103 S.Ct. at 2942 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272, 98 S.Ct. 2340, 2344, 57 L.Ed.2d 107, 204 (1978)) (citations omitted; emphasis in original).

At bottom, in order to prove a violation of due process, a taxpayer must clearly and cogently prove the apportionment formula, as applied, "has led to a grossly distorted result" or that "the income attributed to the state is in fact out of all proportion to the business transacted . . . in that State." *NCR Corp. v. Comptroller of the Treasury, supra*, 313 Md. 118, 544 A.2d at 779 (quoting *Container Corp.*, 463 U.S. at 170, 103 S.Ct. at 2942). NCR asserts that unfairness results from South Carolina's taxing scheme because no foreign subsidiary property, payroll, or sales are considered in the denominator of South Carolina's apportionment formula for determining NCR's percentage of business conducted in South Carolina, while at the same time income generated at least in part by those foreign subsidiaries is included in NCR's income subject to taxation. We have located three other state court decisions addressing this question.

In *American Tel. and Teleg. Co. v. Wisconsin Dept. of Rev.*, 143 Wis.2d 533, 422 N.W.2d 629 (1988), the Wisconsin Court of Appeals dealt with this issue. First the court noted that:

> Commentators, however, have recognized that future constitutional attacks on state taxation of unitary businesses may focus, as does A.T.&T.'s attack, on apportionment formulas which allegedly give insuffi-

> cient weight to the sales, property, and payroll of subsidiaries which make dividend, interest, royalty, and other payments to the parent corporation which are included by the taxing state as income subject to apportionment.

422 N.W.2d at 635. The court then stated, "[t]he simple but controlling question is whether the state (of Wisconsin) has given anything for which it can ask return." *Id.* at 636. Answering this rhetorical question, the court held,

> Wisconsin has given to A.T.&T. the privilege of carrying on business in the state. It has provided its Long Lines Department protection, governmental services and the benefits of orderly, civilized society. But the taxes which Wisconsin exacts from A.T.&T. are grossly disproportionate to the benefits conferred.
>
> . . . .
>
> [W]e conclude the apportionment formula used by the department does not reflect a reasonable sense of how A.T.&T.'s income is generated and taxes value earned outside the borders of Wisconsin . . . .

Id. at 636.

The opposite of this decision can be found in *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989). That case had virtually identical facts as the instant case. Finding that the increase in NCR's taxes from the application of the apportionment formula was 23% when compared to what NCR's taxes would be if a proportionate measure of the foreign subsidiaries' sales, property, and payroll were factored in, the Minnesota Supreme Court held that this distortion was not "outside the substantial margin of error" allowed, and was not grossly disproportional to the activity carried on in Minnesota by NCR. 438 N.W.2d at 93. The Minnesota Supreme Court pointed out the United States Supreme Court has ruled that a gross disparity existed when there was a 250% increase in tax, *see Hans Rees Sons, Inc. v. North*

Carolina, 283 U.S. 123, 51 S.Ct. 385, 75 L.Ed. 879 (1931), but that one does not exist when there was an increase of 14%. *See Container Corp., supra.* The Minnesota Court then concluded 23% was more like the *Container Corp.* decision than *Hans Rees Sons.*[6]

Finally, the Court of Appeals of Maryland also addressed this issue in *NCR Corp. v. Comptroller of the Treasury*, 313 Md. 118, 544 A.2d 764 (Ct. App. 1988). That case also involved very similar facts as the instant case. The Maryland Court first noted that "NCR is correct in asserting that the formula, as applied to it, does not produce ideally fair results . . . . The question becomes whether NCR has demonstrated that the existing distortion is so grossly disproportionate that it is unconstitutional." *Id.*, 544 A.2d at 780.

We agree with the reasoning of the Court of Appeals of Maryland. South Carolina's taxing scheme is not ideally fair. To a degree, the income received by NCR from its foreign subsidiaries was earned in the United States (and to an extent in South Carolina) as it was partly here where loan monies were created and patents developed and researched. Hence, domestic payroll, property, and sales which are related to producing this royalty and interest income (like domestic research and development companies) have already been included in the formula denominator. However, if the wholly owned foreign subsidiary did not exist, no royalty or interest income could be generated for NCR, obviously.

In this vein, the Maryland Court held, dealing with dividends rather than royalty and interest income:

> [i]t may not be unreasonable to suggest that inclusion of subsidiaries' dividends in the apportionable income [of NCR] should be balanced by some changes in the formula denominator. But the balancing should not

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[6] Obviously, taxing schemes producing such disparities, expressed in percentages, must be resolved on a case-by-case basis.

> be done by including the total property, sales, and payroll values. . . . Instead, the denominators should be modified by including only those percentages of the foreign subsidiaries' property, payroll, and sales that generated the foreign subsidiary dividend income taxed by Maryland.

Id., 544 A.2d at 781. We adopt the Court of Appeals of Maryland's reasoning that:

> we are unable to determine [from the record],[7] in any meaningful way, the extent to which a reasonably structured formula . . . might differ in its results from a formula which excludes that portion of the foreign subsidiary property, payroll, and sales which generated the dividend income. As a further consequence, we cannot tell whether disproportionality [a grossly distorted result] of constitutional proportions is present here.

Id.

Because the trial court did not adequately consider this disproportionality issue, we remand this case to the lower court for a re-factoring of the formula, considering in the formula denominator the proportionate measure (as determined by the trial court led by the broad guidelines set out in this opinion) of the foreign subsidiaries' property, payroll, and sales which generated the NCR income. Once this is done, the new tax amount should be figured and compared with the tax amount presently assessed against NCR by the Tax Commission. If the trial court finds there is a gross disparity between the two amounts of constitutional proportions, it shall order the new tax amount to be assessed and refund granted. If no gross distortion exists upon a comparison of the tax amounts, the original

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[7] This case is unlike *American Tel. & Teleg. Co., supra, NCR Corp. v. Commissioner, supra; Container Corp., supra*; and *Han* [sic] *Rees Sons, supra*, in which the courts were able to determine from the record whether a "grossly distorted result" was produced from the taxing scheme.

tax assessed against NCR shall stand and NCR shall not be entitled to any refund.

Accordingly, the judgment of the lower court is AFFIRMED IN PART AND REMANDED.

GREGORY, C.J., HARWELL, CHANDLER and FINNEY, JJ., concur.

APPENDIX E

STATE OF SOUTH CAROLINA)
)
COUNTY OF RICHLAND)

IN THE COURT OF COMMON PLEAS

Case No. 88-CP-40-1053

NCR CORPORATION,
Plaintiff,

-versus-

SOUTH CAROLINA TAX COMMISSION,
Defendant.

FINAL ORDER

[Filed Feb. 23, 1990]

An Order dated October 2, 1989, was previously issued by this Court as a Final Order in this matter. Following the filing of said Order, a motion under Rule 59 was made by NCR Corporation to alter or amend that Order. Upon consideration of the motion, the Court has determined that the prior Order of October 2, 1989, is withdrawn and the following Order is issued in its place as the Final Order by this Court.

This case came before this Court as the result of a dispute over South Carolina corporate income tax. After hearing the evidence and receiving extensive Briefs by both parties, this Court concludes the tax as assessed by the Defendant is proper and that no refund of any tax should be made.

FACTS

NCR is a multinational corporation whose business is the developing, manufacturing, marketing, installing, and servicing of business information processing systems. All phases of NCR's business are conducted in South Carolina. The West Columbia plant develops, manufactures, and markets NCR's line of Tower computers. NCR's plant in Liberty, South Carolina, manufactures personal computers, and NCR has several retail and service offices in South Carolina, including offices in Columbia and Greenville. Products produced in South Carolina are distributed and sold throughout NCR's worldwide market.

NCR received royalty income from its unitary foreign subsidiaries. The royalty income pertinent to this action is received from foreign subsidiaries pursuant to patent licensing agreements under which NCR authorizes the foreign subsidiary to manufacture and sell NCR's patented machines.[1] The foreign subsidiaries are owned 100% by NCR, with the exception of NCR's subsidiary in Japan which is owned 70% by NCR. Royalties received by NCR from its foreign subsidiaries were as follows:

1981	1982	1983
$32,996,316	$39,242,371	$49,992,119

NCR also received substantial interest income from its unitary foreign subsidiaries. Interest income pertinent to this action resulted from four areas: NCR's financing of its foreign subsidiaries' accounts receivable, NCR's direct loans to the foreign subsidiaries, funds generating interest identified as I.R.C., Section 904(d) interest, and NCR's

[1] NCR also received royalties from what it calls domestic sources as well. NCR's Exhibit 18 identifies domestic royalties as follows:

1981	1982	1983
$145,854	$129,437	$93,368

funds deposited in foreign countries.[2] Interest income from these areas was as follows:

1981	1982	1983
$18,304,080	$23,924,409	$16,562,396

Because NCR receives royalty and interest income from its activities in foreign countries, the various laws of those countries impose a withholding tax on such income. The withholding tax on royalty income and on interest income is as follows:

	1981	1982	1983
Royalties	$1,463,093	$1,729,928	$2,204,996
Interest	4,379,925	4,147,747	1,686,336

In computing its apportionable income for the tax year 1981, NCR excluded 100 percent of the gross foreign royalties and interest paid to NCR by its unitary foreign subsidiaries. On audit of the 1981 tax year, the South Carolina Tax Commission (hereinafter "Commission") included the foreign source royalties and interest in NCR's apportionable income and did not allow NCR to adjust the apportionment formula by adding to its ratios the property, payroll, and sales of its unitary subsidiaries.

In computing its apportionable income for tax years 1982 and 1983, NCR included foreign royalties and interest in its apportionable income but correspondingly increased the denominator of the apportionment formula by adding to its property, payroll, and sales the property, payroll, and sales of its foreign subsidiaries. On audit of the 1982 and 1983 tax years, the Commission removed from NCR's apportionment ratio the property, payroll, and sales of NCR's foreign subsidiaries. Such adjustment

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[2] NCR also receives substantial interest income from what NCR calls domestic source. NCR's Exhibit 14 identifies domestic source interest as follows:

1981	1982	1983
$17,959,824	$21,258,776	$25,109,476

was made since only NCR's income was being taxed, while none of the income of the subsidiaries was being taxed.

NCR disagreed with the Tax Commission's adjustments and paid $499,007 under protest. This action was then brought under Section 12-47-220.

ISSUES

Several issues were raised before this Court. However, after negotiations and discussions by the parties, four issues were removed.[3] There are three issues now remaining and each is discussed and decided in this Order.

I. Do South Carolina's Taxing Statutes Violate The Foreign Commerce Clause By Including In Apportionable Income Interest And Royalties Received From Its Unitary Foreign Subsidiaries?

After reviewing the evidence and arguments before the Court, the Court finds no violation of the Foreign Commerce Clause by any of South Carolina's taxing statutes challenged by NCR. In order to properly address the issue which is before the Court, an examination of South Carolina's statutes in light of the Foreign Commerce Clause is appropriate.

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[3] Issues which have been expressly withdrawn by the parties without prejudice to future litigation concerning later tax years not here in dispute are: (1) whether interest income from so-called "domestic sources" is apportionable or instead allocated to NCR's corporate headquarters in Ohio, (2) whether the sales factor of the apportionment formula should include in its denominator the entire gross receipts from a sale or should it include only the gain derived from the sale, (3) whether withholding tax paid to foreign countries is deductible under Section 12-7-700(4) as it existed for tax years 1982, 1983, and 1984, and (4) whether interest income identified as "I.R.C. 904(d) interest income" and "unrelated-party foreign interest income" is apportionable or instead allocated to Ohio as NCR's corporate headquarters. These issues are not before the Court and will not be addressed in this Order.

A. *Allocation to Foreign Countries*

South Carolina enacted Act 731 in 1958 to establish a system for determining how much of a taxpayer's income would be taxable in South Carolina. The statutory scheme imposes an income tax upon a base which reasonably represents the proportion of the trade or business carried on within South Carolina. *Hertz Corp. v. South Carolina Tax Commission*, 246 S.C. 92, 142 S.E.2d 445 (1965); *Lockwood Greene Eng. v. South Carolina Tax Commission*, 293 S.C. 447, 361 S.E.2d 346 (1987), and Section 12-7-250.

The base upon which South Carolina imposes its income tax is determined in two steps, both of which are identified in Article 9 of Title 12 as "Allocation or Apportionment of Income." The first step is allocation. Section 12-7-1120 explains that certain classes of income less related expenses are allocated, *i.e.*, taxed at a designated location.

In the instant case, NCR argues that its royalty and interest income should be allocated. NCR argues that the royalty and interest income in question was both earned in and taxed by the foreign jurisdictions and that, when such occurs, the Foreign Commerce Clause of the United States Constitution requires allocation of the income to those foreign countries.

NCR does not argue that the statutes of South Carolina require allocation. Rather, it asserts the tax imposed is unconstitutional since the Foreign Commerce Clause of the United States Constitution requires allocating to foreign countries the royalty and interest income. NCR asserts that to not allocate away such income "constitutes inevitable international multiple taxation and prevents the United States from speaking with one voice" in foreign commerce. The Court disagrees with these assertions and finds that no violation of Foreign Commerce results by not allocating to foreign countries the royalty and interest income here in dispute. The Court's

basis for this conclusion is developed more fully in "B" below since NCR makes the same Foreign Commerce arguments in asserting it is not required to apportion its royalty and interest income. The Tax Commission has argued that such income must be apportioned. It is this issue of apportionment that raises the second step of South Carolina's statutory scheme in determining the reasonable base of income subject to tax. Such is addressed below.

B. *Apportionment*

Apportionment is required by Section 12-7-1140, which states the following:

> "Net income of the above classes having been separately allocated, a taxpayer whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State, shall make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the arithmetical average of the three ratios stated in Sections 12-7-1150 to 12-7-1170."

After allocating specific classes of income less related expenses, NCR is subject to a formula that will determine the "proportion of its remaining net income" which is taxable in South Carolina. The formula is the average of three ratios: NCR's property in South Carolina as a percentage of NCR's property everywhere (*see* Section 12-7-1150); NCR's payroll in South Carolina as a percentage of NCR's payroll everywhere (*see* Section 12-7-1160); and NCR's sales in South Carolina as a percentage of NCR's sales everywhere (*see* Section 12-7-1170). The average of these three percentages is then multiplied by the remaining net income to give South Carolina apportionable income. NCR has challenged the apportionment statutes as being unconstitutional.

NCR argues that the apportionment formula is unconstitutional by its inclusion of royalty income and interest income from NCR's foreign subsidiaries. NCR argued before this Court that taxing such income violated the Foreign Commerce Clause on two grounds: such taxation creates inevitable multiple taxation and prevents the United States Government from "speaking with one voice" in regulating foreign commerce.[4] This Court finds no violation.

1. *No Inevitable Multiple Taxation Is Present*

Before there can be a finding that the apportionment formula "inevitably" creates multiple taxation, there must first be a finding that the royalty and interest income here in dispute have actually been subjected to multiple taxation by the formula. Such has not been shown here.

No showing of double taxation is present since such a view is premised on demonstrating that an identified

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[4] The taxpayer's grounds are based on the United States Supreme Court's tests for finding a violation of the Foreign Commerce Clause. The tests originated in a property tax context as follows:

> "In addition to answering the nexus, apportionment, and nondiscrimination questions posed in Complete Auto, a Court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation and, second, whether the tax prevents the federal government from 'speaking with one voice when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts, it is unconstitutional under the commerce Clause. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451."

Further, the first test of "substantial risk of international multiple taxation" has been altered for an income tax such as is before this Court. The test was modified to state that a "method of formula apportionment [that] 'inevitably' led to double taxation . . . might be reason enough to render it suspect." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 195, 103 S.Ct. 2933, 2955 (1983).

class of income is taxed by one party and that the same identified income is taxed by a second party. Here, the royalty and interest income was subject to tax under various treaties which allowed the income to be taxed by the "source nation," with the "source nation" being the place where the income originates.

South Carolina has not taxed the same royalty or interest income taxed by the foreign countries. Rather, South Carolina, in its apportionment formula, taxed only unitary income. Unitary income has no identifiable source but is merely a concept employed to determine what amount of income is properly "earned" in South Carolina. The mere fact that interest and royalty income are included in the preapportionment base does not mean that South Carolina is, in fact, taxing that specific income. Such a view was established in *Shell Oil Co. v. Iowa Dept. of Revenue*, 109 S.Ct. 278 (1988).

> ". . . . But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa. As our Commerce Clause analysis of apportionment formulas has made clear, the inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation. *Shell, supra*, at p. 284."

Thus, in the instant case, there is, in fact, no double taxation shown.

The Court uses the term unitary income to mean NCR's income alone and not the combined income of NCR and its subsidiaries. NCR takes a different view. NCR agreed it is conducting a unitary business with its foreign subsidiaries, but it argued the royalty and interest

income in question is not a part of what it refers to as its unitary operating income (also referred to by NCR as its "combined income") which it argues is specifically earned and taxed in the foreign jurisdictions and should, therefore, be allocated to those foreign jurisdictions. The terms "combined income" and/or "unitary operating income" as applied by NCR mean the income which would result if NCR's subsidiaries were operated as Divisions of NCR and all corporations were combined into one single corporate entity.

NCR argued that royalty and interest income from its subsidiaries are not a part of what it refers to as its unitary operating income or combined income. NCR contends that royalty and interest income are not a part of its unitary operating or combined income because intercompany transactions eliminate them in a combined return. Although this contention is correct, it has no relevance to the case at hand. Whether or not the royalties and interest are eliminated in a combined return does not change NCR's tax liability, since South Carolina does not tax combined income.

The Tax Commission has used the term "unitary income" to mean NCR's income and not the combined income of NCR and its subsidiaries. The Loan Agreements and Patents employed and used in the foreign countries by NCR which earn the interest and royalties here in dispute are used in NCR's business. Further, the income from these Loan Agreements and Patents was used in the Taxpayer's business in the United States. The Commission argued the royalties and interest received by NCR from NCR's unitary subsidiaries were unitary with respect to NCR. The Court agrees with the view of the South Carolina Tax Commission.

While the Court finds there is no double taxation in fact, this Court further finds that even if double taxation could be established, there is no violation of the Foreign Commerce Clause since here it is established that any

such taxation is not "inevitable." This view is established in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

Container, supra, held that in an income tax context multiple taxation occurs only in the sense that some of the income taxed by the foreign nations is part of the computation of the state's share of the unitary business. *Container,* 463 U.S. at 187. This so-called multiple taxation is not the inevitable result of South Carolina's apportionment formula but, rather, is the result of different jurisdictions applying different formulas of taxation. *Container, supra,* 463 at 189, found that multiple taxation under this circumstance is not fatal:

> ". . . such an absolute rule is no more appropriate here than it was in *Japan Line* itself, where we relied on much more than the mere fact of double taxation to strike down the state tax at issue. Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account *the context* in which the double taxation takes place *and the alternatives reasonably available to the taxing State.* (Emphasis added)."

NCR's multiple taxation argument rests on the faulty premise that multiple taxation of the same income in the international context is, per se, invalid under the Commerce Clause. NCR's argument ignores the "context" of such alleged multiple taxation and the "alternatives" available to South Carolina to eliminate any alleged multiple taxes.

South Carolina could eliminate one of the taxes by not taxing NCR's income at all. But, the "obvious unfairness" of such a rule "requires no elaboration", 463 U.S. at 190, 77 L.Ed.2d at 569, or South Carolina "could try to avoid double taxation by adopting some version of the " 'arms-length' approach" whereby foreign interest and royalties would be allocated, rather than apportioned,

but such a course "would not, by any means, guarantee an end to double taxation." *Ibid.* In this regard, "even though most nations have adopted the arms-length approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists, the possibility of double taxation also exists." 463 U.S. at 191, 77 L.Ed.2d at 570. "Thus, even if [South Carolina] were to adopt some version of the arms-length approach, it could not eliminate the risk of double taxation of corporations subject to its [income] tax and might, in some cases, end up subjecting those corporations to more serious double taxation than would occur under formula apportionment." *Ibid.* It is the Court's finding that these conclusions of the *Container* court as to the impracticability of eliminating the so-called multiple taxation are equally applicable to NCR's foreign interest and royalties.

Further, it is the Court's view that multiple taxation of NCR's interest and royalties (which, admittedly, were received from unitary subsidiaries) cannot be established based on asserting that such income is taxed by a foreign country under a geographical arms-length approach to taxation. *Container*, 463 U.S. at 182, 77 L.Ed.2d at 564. The *Container* decision reiterated this position by its citations of *Mobil Oil Corp. v. Com. of Taxes*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980).

> ". . . separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is

not constitutionally required. 445 U.S. at 438, 100 S.Ct. at 1232 (citation omitted)." *Container, supra,* 463 U.S. at 181.

Further, this Court finds that NCR's multiple taxation argument leads to an anomalous result. Under NCR's view, the entire income of the foreign subsidiary could be constitutionally included in NCR's preapportioned net income base for purposes of computing taxable income on a combined report basis such as is used by states like California. However, a *lesser* amount of those same earnings, representing interest and royalties, could not be constitutionally included in NCR's preapportioned net income base if a State, like South Carolina, opts to use the unitary method upheld in *Mobil Oil.* It is unreasonable to subject South Carolina's unitary tax structure to more stringent Commerce Clause requirements, with respect to multiple taxation, than the *Container* court applied to the California combined report method. Had South Carolina employed the combined report method, NCR's multiple taxation argument would be foreclosed. It is improper for that argument to gain acceptance merely because South Carolina includes less than the full foreign subsidiary earnings in NCR's preapportioned unitary net income base.

For the above reasons, this Court finds no foreign commerce clause violation. *Container* is dispositive. As in *Container,* the situation in the instant case does not involve direct taxation of foreign subsidiary earnings but involves a tax upon NCR's South Carolina income-producing activities. NCR's argument of inevitable multiple taxation caused by South Carolina is incorrect.

2. ***No Interference With Federal Uniformity Is Present***

The second test relevant to a Foreign Commerce Clause analysis is whether the tax impairs federal uniformity in dealing with foreign commerce. Again, *Container, supra,*

has specifically found the standard three-factor formula for taxing income to be a proper method. *Container* explained as follows:

> "In conducting this inquiry, however, we must keep in mind that if a state tax merely has foreign resonances but does not implicate foreign affairs, we cannot infer, '[a]bsent some explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States.' *Mobil*, 445 U.S. at 448, 100 S.Ct. at 1237. *See also Japan Line, supra*, 441 U.S. at 456, n. 20, 99 S.Ct. at 1825, n. 20; *Michelin Tire Corp., supra*, 423 U.S. at 286, 96 S.Ct. at 541. Thus, a state tax at variance with federal policy will violate the 'one voice' standard if it either implicates foreign policy issues which must be left to the Federal Government or violates a clear federal directive. The second of these considerations is, of course, essentially a species of preemption analysis."
>
> 103 S.Ct. at p. 2955.

Container found there was no hindrance to the federal government's authority to speak with "one voice." Further, there was no "clear federal directive" which is violated by the use of the three-factor formula. In light of the United States Supreme Court's specific and concrete holding on this identical issue, there can be no conclusion other than one finding no violation of the "one voice" test of Container.

II. Do South Carolina's Taxing Statutes Provide For An Adjustment to The Apportionment Formula?

NCR argues that including its foreign royalty and foreign interest in apportionable income requires adjustments to be made to the apportionment formula. The "adjustment" NCR seeks is to have the property, payroll, and sales of its foreign subsidiaries added to NCR's own property, payroll, and sales. The result of this adjustment is

that a smaller percentage would be applied to NCR's net income, giving a smaller South Carolina taxable net income. This Court finds that the statutes do not provide for such an adjustment.

The language of the statutes establishing the property, payroll, and sales ratio includes only the property, payroll, and sales of the single taxpayer, NCR, and not the combined ratios of NCR and its subsidiaries. Each statute uses the singular word "taxpayer" rather than the plural word "taxpayers."

> "The ratio of the average value of real estate and tangible personal property, as defined in this section, used by such *taxpayer* in this State during the income year, to the average value of the entire real estate and tangible personal property, as defined in this section, used by the *taxpayer* everywhere during the income year. . . .
>
> Section 12-7-1150 for property. (Emphasis added).
>
> The ratio of all salaries, wages, commissions, and other personal service compensation paid or incurred by the *taxpayer* in connection with the trade or business of the *taxpayer* in this State during the income year to the total salaries, wages, commissions, and other personal service compensation paid or incurred by the *taxpayer* in connection with the entire trade or business of the *taxpayer* wherever conducted during the income year. . . .
>
> Section 12-7-1160 for payroll. (Emphasis added).
>
> The ratio of sales made by such *taxpayer* during the income year which is attributable to this State to the total sales made by such *taxpayer* everywhere during the income year. . . ."
>
> Section 12-7-1170 for sales. (Emphasis added).

The word "taxpayer" is not ambiguous, and in the absence of an ambiguity, the language of a tax statute must

be given its plain, ordinary meaning. *Beach v. Livingston,* 248 S.C. 135, 139, 149 S.E.2d 328, 330 (1966).

Emerson Electric Company v. Wasson, 287 S.C. 394, 339 S.E.2d 118 (1986), found that the sales ratio of Section 12-7-1170 was to be computed based on the separate sales of each taxpayer even when two corporations were filing together on a consolidated return. Thus, if the ratios must be computed separately for each corporation in a consolidated return, how much more must such be required in the instant case when NCR files as a single taxpayer? It cannot be emphasized too strongly that South Carolina is not taxing the net income of NCR's subsidiaries, whether they are foreign or domestic. Rather, South Carolina is taxing only the net income of NCR as a single corporate taxpayer. Since only NCR, as a single taxpayer, is being taxed, the statutes do not allow including NCR's foreign subsidiaries in calculating NCR's property, payroll, and sales.

NCR's argument that the ratios should include its subsidiaries' property, payroll, and sales has been rejected in two other jurisdictions. In Maryland, *NCR Corp. v. Comptroller of the Treasury,* 544 A.2d 764 (1988), the Court said:

> ". . . it is the taxpayer's property, sales, and payroll values, in Maryland and in total or everywhere, that enter the formula. 'The taxpayer' does not, of course, include the taxpayer's subsidiaries or their property, sales, and payroll values, just as the subsidiaries' income is not included. . . ."

Minnesota also rejected NCR's argument in *NCR Corp. v. Commissioner of Revenue,* 438 N.W.2d 86 (1989). There, the Minnesota Supreme Court stated:

> "Because NCR is the only 'taxpayer' involved in this case, the apportionment statute contemplates that only its factors of property used, payroll paid, and sales made are relevant for inclusion in the denominator of the apportionment function. Therefore,

> NCR's construction argument must be rejected. The Commission properly excluded sales made, payroll paid, and property used factors of [NCR's] foreign subsidiaries from the apportionment formula."

The language of South Carolina's apportionment statutes looks to the property, payroll, and sales of a single taxpayer, not those of NCR plus its subsidiaries. Further, the identical argument by NCR has been rejected by Maryland's and Minnesota's highest courts. Finally, *Emerson Electric, supra,* decided by our Supreme Court, requires the ratios to apply to only a single corporation and not to a combined group of corporations. Thus, this Court must reject NCR's argument.

III. Does The Lack Of An Adjustment To The Apportionment Formula Cause South Carolina's Formula To Be In Violation Of Due Process, Interstate Commerce, Or Foreign Commerce?

NCR argued that the United States Constitution is violated by South Carolina's statutes not including the foreign subsidiaries' property, payroll, and sales in computing NCR's South Carolina apportionable income. The argument is that failure to include these elements from the foreign subsidiaries violates Due Process, Interstate Commerce, and Foreign Commerce. This Court finds no violation.

A. *No Due Process Or Interstate Commerce Violation Occurs Under South Carolina's Statutes*

The test for determining whether an apportionment statute violates Due Process or Interstate Commerce is the same and has been clearly set out by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 103 S.Ct. 2933 (1983). There, the following was established:

> ". . . an apportionment formula must, under both the Due Process and Commerce Clauses, be fair.

> *See Exxon Corp., supra,* 447 U.S. at 219, 227-228, 100 S.Ct. at 2118, 2122-2123; *Moorman Mfg. Co.,* 437 U.S. at 272-273, 98 S.Ct. at 2343-2344; *Hans Rees' Sons, Inc.,* 283 U.S. at 134, 51 S.Ct. at 389. The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not 'invalidat[e] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State. . . .' *Moorman Mfg. Co., supra,* 437 U.S. at 272, 98 S.Ct. at 2344 (emphasis added). *See Underwood Typewriter Co.,* 254 U.S. at 120-121, 41 S.Ct. at 46-47. Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove 'by "clear and cogent evidence" that the income attributed to the State is, in fact, "out of all appropriate proportions to the business transacted . . . in that State," [*Hans Rees' Sons, Inc.*] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [*Norfolk & Western R. Co. v. State Tax Comm'n.,* 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.E.2d 1201 (1968)].' *Moorman Mfg. Co., supra,* 437 U.S. at 274, 98 S.Ct. at 2345."

South Carolina's statutes are not unconstitutional since the tests of internal consistency and external consistency are satisfied.

1. *Internal Consistency Is Satisfied*

The internal consistency test is satisfied if the taxing formula is such that, if applied by every jurisdiction, no more than all of the unitary income of the taxpayer would be taxed. In this case, South Carolina's statute, if adopted by everyone, would tax no more than 100% of NCR's income. This is true since the formula is based on the percentage of NCR's total property, payroll, and sales which is in each state. Under such a formula, it is impossible for there to be more than 100% of NCR's income taxed, since each state would use the same factors of property, payroll, and sales but would tax only that percentage of income based on property, payroll, and sales in that state. Minnesota, which has virtually the same three-factor formula as South Carolina, held that the three-factor formula was internally consistent in *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86, 1989 West Law 13846 (1989).

> "In our view, NCR has fallen far short of meeting its burden of demonstrating any internal inconsistency of Minnesota's apportionment formula. . . ."

South Carolina's three-factor formula is likewise internally consistent.

2. *External Consistency Is Satisfied*

The second test of a valid apportionment formula is whether the factors used in the apportionment formula reflect a reasonable sense of how income is generated.

> "The external consistency test asks whether the state has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."
>
> *Goldberg v. Sweet*, 109 S.Ct. 582 (1989).

Does the three-factor formula reasonably reflect the in-state component of the overall activities of NCR? The United States Supreme Court has explicitly found the

three-factor formula is a reasonable and fair method for apportioning the unitary income of a taxpayer.

> "California and the other States that have adopted the Uniform Act use a formula—commonly called the 'three-factor' formula—which is based, in equal parts, on the proportion of a unitary business' total payroll, property, and sales which are located in the taxing State. *See* Cal. Tax & Rev. Code Ann., Sections 25128-25136 (West 1979). We approved the three-factor formula in *Butler Bros. v. McColgan,* 315 U.S. 501, 62 S.Ct. 701, 86 L.Ed. 991 (1942). Indeed, not only has the three-factor formula met our approval, but it has become, for reasons we discuss in more detail *infra,* at 2949, something of a benchmark against which other apportionment formulas are judged. *See Moorman Mfg. Co., supra,* at 282, 98 S.Ct. at 2349 (Blackmun, J., dissenting); *cf. General Motors Corp. v. District of Columbia,* 380 U.S. 553, 561, 85 S.Ct. 1156, 1161, 14 L.Ed.2d 68 (1965)."
>
> *Container Corp., supra, at* 103 S.Ct. 2943.

In fact, the Supreme Court, as recently as April 3, 1989, restated its conviction that the three-factor formula gives fair apportionment.

> "Nor has New Jersey imposed upon appellants an unfairly apportioned tax. New Jersey employs an apportionment formula that averages the percentages of in-state property, receipts, and payroll. *See* Part I-B, *supra.* We have expressly approved this apportionment formula in the past. *See, e.g., Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 170 (1983). Indeed, this three-factor formula has become . . . something of a benchmark against which other apportionment formulas are judged. *Ibid.*"
>
> *Amerada Hess Corp. v. Director, New Jersey Dept. of Treasury,* 109 S.Ct. 1617, 1989 W.L. 28807 (1989).

Since the three-factor formula is an approved apportionment method, NCR has the burden of demonstrating the apportionment is unfair.

> "We turn now to the question of fair apportionment. Once again, appellant has the burden of proof; it must demonstrate that there is 'no rational relationship between the income attributed to the State and the intrastate values of the enterprise,' *Exxon Corp.*, 447 U.S. at 220, 100 S.Ct. at 2118, quoting *Mobil, supra,* 445 U.S. at 437, 100 S.Ct. at 1231, by proving that the income apportioned to California under the statute is 'out of all appropriate proportion to the business transacted by the appellant in that State.' *Hans Rees' Sons, Inc.*, 283 U.S. at 135, 51 S.Ct. at 389."
>
> *Container Corp., supra,* 103 S.Ct. at 2948.

NCR has failed to demonstrate there is "no rational relationship between the income attributed to [S.C.] and the intrastate values of the enterprise."

The rational relationship between the income attributed to South Carolina and the intrastate values of NCR require determining three elements. First, what income is attributed to South Carolina; second, what are the activities of NCR in South Carolina; and finally, whether the activities in South Carolina are rationally related to the income taxed here.

The income which is taxed by South Carolina is NCR's unitary income. The interest and royalty income here in dispute resulted from intangible assets, specifically the Loan Agreements and Patents, employed in the Taxpayer's business in the foreign countries. Further, the income itself was used in the Taxpayer's business in the United States. The unitary income, by its very nature, cannot be identified as resulting from particular sources. Rather, unitary income reflects the efforts of profitability generated from numerous but unidentified sources.

The business activities NCR performs in South Carolina consist of the entire range of unitary activities. As the testimony reflected, NCR had two manufacturing plants in South Carolina, and NCR developed and marketed a line of computers from its West Columbia facility. Retail and service outlets are present throughout the state, and products produced in South Carolina are distributed worldwide. NCR also manufactures personal computers at its facility in Liberty, South Carolina.

Given the unitary nature of NCR's business and the extensive facilities generating property, payroll, and sales in South Carolina, such factors are rationally related to the activities producing the unitary income. Thus, the Court finds NCR has failed to show there is "no rational relationship" between the income South Carolina taxes and the three-factor formula used to determine South Carolina's percentage of NCR's unitary income.

Finally, as to the external consistency test, in addition to asserting there is no rational relationship between the South Carolina income and the South Carolina activities of NCR, the taxpayer has attempted to show the formula leads to apportioning income to an extent that is "out of all appropriate proportion to the business transacted by the appellant in that State." *Container Corp., supra,* at 2948. NCR has not shown this gross distortion.

Concerning distortion, our South Carolina Supreme Court in *Covington Fabrics v. South Carolina Tax Commission,* 264 S.C. 59, 202 S.E.2d 574, 577 (1975), held the following:

> "Although exactness in apportionment is desirable, all that is required is a reasonable approximation.
>
> 'Furthermore, this Court has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities such as those of appellant and has declared that "rough approximation rather than precision" is

> sufficient. *Illinois Central Ry. Co. v. State of Minnesota,* 309 U.S. 157, 161, 60 S.Ct. 419, 84 L.Ed. 670. Unless a palpably disproportionate result comes from an apportionment, a result which makes it patent that the tax is levied upon interstate commerce rather than upon an interstate privilege, this Court has not been willing to nullify honest state efforts to make apportionments.' *International Harvester Co. v. Evatt,* 329 U.S. 416, 67 S.Ct. 444, 91 L.Ed. 390, *reh. den.,* 329 U.S. 834, 67 S.Ct. 628, 91 L.Ed. 706."

The reluctance of the United States Supreme Court to conclude a formula created a gross distortion is established in *Butler Bros. v. McColgan,* 315 U.S. 501 (1942). There, a three-factor formula apparently caused a 1,500% increase in tax compared to the tax under the taxpayer's view. Despite this, the Court found the formula proper.

The Court notes that both Minnesota and Maryland were presented with this same argument by this same taxpayer. In both jurisdictions, the courts found NCR had no gross distortion caused by taxing royalties and interest.

After reviewing the evidence, this Court concludes there is no gross distortion present in this case sufficient to constitute a violation of Due Process. The Tax Commission presented evidence demonstrating that the total exclusion of all of what NCR identified as foreign royalties and foreign interest (thus, avoiding the alleged need for adjusting the apportionment factors) shows an average increase in taxes paid to South Carolina of 5.5%. On the other hand, NCR, using different methodology, presented evidence attempting to show an average increase in taxes paid to South Carolina of between 58.2% to 65.8%. This Court finds the Tax Commission's evidence correctly demonstrates the increase in tax due to excluding foreign royalties and interest. Such a minor difference as 5.5% is well within the limits of the Due Process requirements. In any event, the Court further

finds that even if a 65.8% increase could have been established, such is not a sufficient increase to violate Due Process or Interstate Commerce. All that is required is a "rough approximation rather than precision." *Covington Fabrics, supra.* This Court is satisfied that no Due Process or Interstate Commerce violation is created by South Carolina's apportionment statutes not including NCR's subsidiaries' payroll, property, and sales in NCR's apportionment factors.

B. *No Foreign Commerce Clause Violation Occurs By South Carolina's Statute Not Including The Payroll, Property, And Sales Of The Foreign Subsidiaries*

This Court has previously concluded that the inclusion in apportionable income of NCR's interest and royalty income is proper and such does not violate the foreign commerce clause. In its argument before this Court, NCR asserted that if its foreign interest and foreign royalties were included in apportionable income, then in order to avoid multiple taxation in violation of the Foreign Commerce Clause, adjustments to the payroll, property, and sales ratio were required. The adjustment sought is the inclusion of the payroll, property, and sales of the foreign subsidiaries as part of NCR's payroll, property, and sales.

This Court finds that the payroll, property, and sales of NCR's subsidiaries may not be added to NCR's payroll, property, and sales. First, such an adjustment is not authorized or allowed by South Carolina's statutes since only the factors of the single taxpayer, NCR, are utilized (see basis for this conclusion in II. of this Order). Second, no violation of the Foreign Commerce Clause occurs by limiting the apportionment factors to those of NCR and excluding those of the subsidiaries.

The test for determining if the Foreign Commerce Clause is violated by an apportionment formula as expressed earlier in this Order has been examined by *Con-*

tainer Corp., supra. There, the Court said two tests are relevant. First, is there an "inevitable risk of multiple taxation" by use of the formula; and second, does the tax "impair federal uniformity in an area where federal uniformity is essential?"

Container found the three-factor apportionment formula did not cause an inevitable risk of multiple taxation. The court found that even if actual double taxation were to occur, such was not absolutely forbidden. The court stated the following:

> "Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing state."
> 463 U.S. at 190, 103 S.Ct. at 2953.

The court then went on to say that no matter what formula the taxpayer used, it would still have a tendency to lead in some instances to double taxation.

> "Allocating income among various taxing jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a shadow. In the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to the tax is quite similar, may just be too much to ask. If California's method of formula apportionment 'inevitably' led to double taxation, *see supra*, at 2952, that might be reason enough to render it suspect. But since it does not, it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation."
>
> 103 S.Ct. 2954-2955.

In the final analysis, *Container, supra,* held that since, in the international context, there is no practical means

to assure that double taxation will not occur, the use of the three-factor formula does not cause an inevitable risk of multiple taxation. Here, since South Carolina employs the same three-factor formula used by California, no Foreign Commerce Clause violation occurs.

Further, the second test of whether the tax would impair federal uniformity is likewise not violated by South Carolina's formula. In *Container*, the court explained as follows:

> "In conducting this inquiry, however, we must keep in mind that if a state tax merely has foreign resonances but does not implicate foreign affairs, we cannot infer, '[a]bsent some explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States.' *Mobil*, 445 U.S. at 448, 100 S.Ct. at 1237. *See also Japan Line, supra*, 441 U.S. at 456, n. 20, 99 S.Ct. at 1825, n. 20; *Michelin Tire Corp., supra*, 423 U.S. at 286, 96 S.Ct. at 541. Thus, a state tax at variance with federal policy will violate the 'one voice' standard if it either implicates foreign policy issues which must be left to the Federal Government or violates a clear federal directive. The second of these considerations is, of course, essentially a species of preemption analysis.' "
>
> 103 S.Ct. at 2955.

The *Container* decision found that no foreign policy issues exclusively in the federal sphere were implicated by the three-factor formula. Likewise, no clear federal directive was violated by the three-factor formula. Further, this Court notes that Minnesota, in *NCR Corp. v. Commissioner of Revenue, supra*, reviewed the same argument and found no Foreign Commerce violation was found. Likewise, this Court finds no violation occurs under South Carolina's virtually identical three-factor formula.

Based on the foregoing, it is the Order of this Court that the tax payment of $499,007 paid under protest by NCR is not to be refunded.

AND IT IS SO ORDERED.

/s/ Thomas L. Hughston, Jr.
THOMAS L. HUGHSTON, JR.
Presiding Judge
Fifth Judicial Circuit

February 22, 1989.

APPENDIX F

STATE OF SOUTH CAROLINA
BEFORE THE
SOUTH CAROLINA TAX COMMISSION

IN RE:

A FINDING CONCERNING THE INCOME TAX LIABILITY OF NCR CORPORATION FOR TAX YEARS 1981, 1982 AND 1983 AND LICENSE FEE LIABILITY FOR 1982, 1983 AND 1984.

[Filed January 22, 1988]

FINDINGS OF FACT

NCR manufactures and sells business machines, equipment and related supplies. It has its principal place of business and corporate headquarters in Dayton, Ohio. NCR has sales and service offices in South Carolina as well as a substantial manufacturing plant located in the state.

NCR has developed a worldwide market for its products by use of foreign subsidiaries. Each subsidiary enters into a licensing agreement whereby NCR allows each subsidiary the right to manufacture and sell business machines and equipment patented by NCR. NCR provides the subsidiaries with all research, engineering, patentable and unpatentable know-how and trade secrets. NCR also makes substantial loans to the subsidiaries. In return the subsidiaries pay interest on the loans and pay as a royalty a percentage of the gross sales by the subsidiary of licensed NCR products. After an audit the matter has been presented to us.

CONCLUSION

Four issues are present. First, since South Carolina has taxed NCR's royalty and interest income, must South Carolina include the subsidiaries' payroll, property and

sales in the denominator when computing the three factor formula for apportioning NCR's income? Second, is the interest income from loans and investments subject to being apportioned or is such allocated? Third, are gains on the sales of foreign exchange contracts part of the denominator in computing the sales ratio? Finally, did the Field Services Division improperly deny a deduction for taxes paid by NCR? Each of these issues is addressed below. We are unable to agree with NCR's positions.

1. *Subsidiaries' Payroll, Property & Sales*

The apportionment statutes in South Carolina tax only the taxpayer's income "which reasonably represents the proportion of the trade or business carried on within this state." Section 12-7-250. See also *Hertz Corp. v. South Carolina Tax Com'n.*, 246 S.C. 92, 142 S.E.2d 445 (1965). That base is found by applying Article 9 of Chapter 7 in Title 12. Under that Article a taxpayer's royalty income is apportioned for a taxpayer conducting a business like NCR's based upon "the arithmetical average of the three ratios stated in Sections 12-7-1150 to 12-7-1170." Section 12-7-1140. The ratios are based upon the taxpayer's property, payroll and sales in this state compared to the taxpayer's property, payroll and sales everywhere. The taxpayer the statute is concerned with is the single corporation, not the corporation plus its subsidiaries. Here South Carolina is taxing only NCR's income and is not taxing the income of NCR's subsidiaries. NCR is a separate taxpayer from its subsidiaries and thus only NCR's property, payroll and sales are considered. We thus find and conclude the payroll, property and sales of NCR's subsidiaries do not enter into the ratios for computing NCR's South Carolina income.

We further find and conclude that not including the property, payroll and sales of NCR's subsidiaries does not violate due process requirements. Due process requires that there be a minimal connection between the interstate activities and the taxing state and that there exist a ra-

tional relationship between the income attributed to the state and the intrastate values of the enterprise. *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 436-437 (1980). The nexus with South Carolina is readily found from NCR's sales, service and manufacturing activities in South Carolina. The rational relationship between the income taxed and the intrastate values of NCR are satisfied by application of South Carolina's three factor formula. This formula does not violate due process so long as it does not attribute income to South Carolina out of all appropriate proportions and is not a grossly distorted result. *Moorman Manufacturing Co. v. Bair,* 437 U.S. 267, 274 (1978). We find there is no gross distortion from South Carolina's application of the three factor formula.

2. *Interest Income Apportioned.*

The question here is whether the interest income in dispute is allocated under Section 12-7-1120(1) or apportionable under Section 12-7-1140. Section 12-7-1120(1) provides as follows:

> "(1) Interest received by the taxpayer from intangible property not connected with the business of the taxpayer and all interest from intangible property of domestic insurance companies less all related expenses shall be allocated to the state in which the principal place of business of a corporation taxpayer is located or in which the domicile of an individual taxpayer is located."

Section 12-7-1120(1) allocates interest income only if the intangible property that produced the interest income is "not connected with the business of the taxpayer". The assets that generated the interest income are connected to NCR's business. The funds used to produce the interest income were from the sale of business machines. The funds are in the nature of short term investments readily available for use in NCR's business. Much

of the interest income resulted from loans to subsidiaries that enable the subsidiaries to sell business machines produced by NCR. It appears that NCR did not segregate the interest income from its general revenue from the sale of business machines but rather commingled the income. In short, the proceeds of the investments were available for the business needs of NCR. We find the loans that generated the interest are connected with NCR's business and thus the interest income in dispute is properly apportioned and may not be allocated. See *Texaco v. Wasson*, 269 S.C. 255, 237 S.E.2d 75, 80 (1977) and *Lone Star Steel Company v. Dolan*, 668 P. 2d 916 (1983).

3. *Sales of Foreign Exchange Contracts*

The Division has included in the denominator of the sales factor gain resulting from the disposition of the exchange contracts. We find such to be proper. This position has been the practice of the Tax Commission since 1977 and is a longstanding administrative position. Such should not be overturned unless cogent reasons for doing so are found. *Emerson Electric Co. v. Wasson*, 287 S.C. 394, 339 S.E.2d 118 (1986). We find no cogent reasons to change the practice. It must be noted that the apportionment formula need not be an exact measure of the taxpayer's business activity but rather must only provide a reasonable approximation. *Covington Fabrics v. South Carolina Tax Commission*, 264 S.C. 59, 212 S.E.2d 574 (1975). Here inclusion of the gain from the foreign exchange contracts provides a reasonable apportionment approach.

4. *Deductibility Of Withholding Taxes*

NCR receives royalty payments and interest payments from its foreign subsidiaries. The foreign countries in which the subsidiaries operate require that a withholding of tax be made on the subsidiaries' payments to the parent. The tax withheld is based upon the fact that the subsid-

iaries generated income. We find the deduction of this tax is prohibited by Section 12-7-700(4). That section denies a deduction for taxes paid based upon a taxpayer's income. Since the tax here is with respect to income, no deduction is proper.

AND IT IS SO FOUND AND ORDERED.

SOUTH CAROLINA TAX COMMISSION

/s/ S. Hunter Howard, Jr.
S. HUNTER HOWARD, JR.
Chairman

/s/ John M. Rucker
JOHN M. RUCKER
Commissioner

/s/ A. Crawford Clarkson, Jr.
A. CRAWFORD CLARKSON, JR.
Commissioner

Columbia, South Carolina

January 22, 1988

APPENDIX G

SOUTH CAROLINA STATUTES INVOLVED*

Sec. 12-7-230. Tax on corporations.—(A) Every corporation organized under the laws of this State, whose entire business is transacted or conducted within this State, shall make a return and shall pay annually an income tax equivalent to five percent of the entire net income received by such corporation during the income tax year, and except as otherwise provided, every corporation organized under the laws of this State, doing or transacting business partly within and partly without this State, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income to be determined as provided in this chapter, and except as otherwise provided, every foreign corporation transacting, conducting, doing business or having an income within the jurisdiction of this State, whether or not the corporation is engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income, to be determined as provided in this chapter. The term "*transacting,*" "*conducting,*" or "*doing business,*" as used in this section shall include the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain.

(B) In the case of any corporate taxable year beginning before January 1, 1989, the rate imposed by subsection (A) does not apply and the following rates apply:

(1) six percent for corporate taxable years beginning before 1988,

---

* With the exception of § 12-7-600, the statutes in effect for the years at issue (1981-83), which were amended over the years in minor respects having no bearing on the controversy before this Court, are substantially similar to the current statutes, reproduced herein.

(2) five and one-half percent for corporate taxable years beginning in 1988.

Sec. 12-7-600. "Net income" defined.—The words "net income" as used in this chapter mean the gross income of a taxpayer less the deductions allowed by this chapter.

Sec. 12-7-1120. Allocation of interest, dividends, patent and copyright royalties, rents, gains and losses, and income from personal services.—The following items of income shall be specifically and directly allocated in accordance with the following provisions before apportionment of the remaining net income, and such items shall not be included in any factor of the apportionment formula:

(1) Interest received by the taxpayer from intangible property not connected with the business of the taxpayer, and all interest from intangible property of domestic insurance companies less all related expenses, shall be allocated to the state in which the principal place of business of a corporation taxpayer is located, or in which the domicile of an individual taxpayer is located.

(2) Dividends received from corporate stocks owned, less all related expenses, shall be allocated to the state in which the principal place of business of a corporation is located or in which the domicile of an individual taxpayer is located.

(3) Rents received from the lease or rental of real estate or tangible personal property, royalties received from tangible property, where the property leased or rented was not used in or was not connected with the trade or business of the taxpayer during the income year, less all related expenses, shall be allocated to the state in which the property was located at the time the income was derived.

(4) Gains and losses from the sale of real property located in this State are allocable to this State, and the

gains and losses from the sale of real property located outside this State shall be allocated to the state in which the real property is located.

(5) Gains and losses from sales of intangible personal property not connected with the business of the taxpayer other than any intangible personal property held for sale to customers in the regular course of business, less all related expenses, shall be allocated to the state of a corporation taxpayer's principal place of business, or of an individual taxpayer's domicile.

(6) All income from personal services received by a resident individual shall be allocated to this State. All income from personal services received by a nonresident individual for services rendered in this State shall be allocated to this State.

Sec. 12-7-1130. Allocation of income from any other investments.—The income less all related expenses from any other investments, including investments in subsidiaries, the net income from which is not properly includable in the net apportionable income of corporations engaged in interstate commerce under the Constitution of the United States because it is unrelated to the business activity of the corporation conducted partly within and partly without South Carolina, shall be allocated to the state in which the business situs of the investment is located; *provided*, that if the business situs of such investment is partly within and partly without South Carolina, it shall be apportioned by use of the same formula as provided for apportioning the net income of the corporation.

Sec. 12-7-1140. Remaining income of certain manufacturers, processors, dealers and others.—Net income of the above classes having been separately allocated, a taxpayer whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling or processing goods and materials within this State, or

(b) selling, distributing or dealing in tangible personal property within this State, shall make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the arithmetical average of the three ratios stated in §§ 12-7-1150 to 12-7-1170.

Sec. 12-7-1150. Remaining income of certain manufacturers, processors, dealers, and others; ratio for property.—(1) The ratio of the average value of real estate and tangible personal property, as defined in this section, used by such taxpayer in this State during the income year, to the average value of the entire real estate and tangible personal property, as defined in this section, used by the taxpayer everywhere during the income year. . . .

Sec. 12-7-1160. Remaining income of certain manufacturers, processors, dealers and others; ratio for payrolls.—The ratio of all salaries, wages, commissions and other personal service compensation paid or incurred by the taxpayer in connection with the trade or business of the taxpayer in this State during the income year to the total salaries, wages, commissions and other personal service compensation paid or incurred by the taxpayer in connection with the entire trade or business of the taxpayer wherever conducted during the income year . . . .

Sec. 12-7-1170. Remaining income of certain manufacturers, processors, dealers and others; ratio for sales.—The ratio of sales made by such taxpayer during the income year which are attributable to this State to the total sales made by such taxpayer everywhere during the income year . . . .

Sec. 12-19-70. Imposition of license tax on corporations generally; rate; minimum tax; time payable.—In addition to all other license taxes or fees or taxes of whatever kind, every corporation required to file the report

by Section 12-19-20 except the corporations enumerated in Section 12-19-100, shall pay to the Commission at the time of filing the report as required by Section 12-19-20 an annual license fee of fifteen dollars plus one mill on each dollar paid to the capital stock and paid in as surplus of the corporation as shown by the records of the corporation on the first day of the income year next preceding the date of filing the report. In no case may the license fee provided by this section be less than twenty-five dollars. The license fee provided for by this section must be paid at the time of filing the report pursuant to the provisions of Section 12-19-20. The phrase "*paid in as surplus*" for the purposes of Chapter 19, Title 12, means the entire surplus of a corporation other than its earned surplus as defined below, and includes any charges against earned surplus reflected in the balance sheet except charges for reserves.

For purposes of this section, "*earned surplus*" means that portion of the surplus of a corporation equal in amount to the balance of its net profits, income, gains, and losses from the date of incorporation, or from the latest date when a deficit was eliminated by application of its capital surplus, after deducting subsequent distributions to shareholders and transfer to stated capital and capital surplus to the extent that such distribution and transfers are made out of earned surplus. Unrealized appreciation of assets shall not be included in earned surplus.

Sec. 12-19-80. Proration of tax where business is conducted partly without the State.—Where a corporation does business in part within this State and in part without this State, or uses a part of its capital within this State and uses a part of its capital without this State, or owns, maintains or operates one or more establishments or plants within this State and owns, maintains or operates one or more establishments or plants without this State, the amount of the license fee provided for in § 12-19-70 shall

be measured by a proportion of the dollars paid to the capital stock and paid in as surplus of the corporation, determined in accordance with the ratios prescribed for purposes of the income tax as set forth in §§ 12-7-1140 to 12-7-1170 and 12-7-1190.

For the purposes of this section the ratios to be used shall be based upon the accounting period of the corporation as regularly established for the purposes of the income tax.

93-1416

Supreme Court, U.S.
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No. 93----

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

NCR CORPORATION,

Petitioner,

v.

SOUTH CAROLINA DEPARTMENT
OF REVENUE AND TAXATION,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

1. Is the Foreign Commerce Clause violated when a State utilizes the standard three-factor formula to tax an apportioned share of the unitary income of a taxpayer when the unitary income includes royalty and interest income derived by the unitary activities of the taxpayer?

2. Where a state taxes the unitary income of a recipient of royalty and interest payments and where the State uses the standard three-factor formula utilized for unitary taxation, is the State required by the Due Process or Commerce Clauses to include in the recipient's factors the payroll, property and sales of the party that paid the royalty and interest?

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No. 93----

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

NCR CORPORATION,

Petitioner,

v.

SOUTH CAROLINA DEPARTMENT
OF REVENUE AND TAXATION,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of South Carolina

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION

Respondent, South Carolina Department of Revenue and Taxation (DOR), respectfully requests that Petitioner's request for a Writ of Certiorari to the Supreme Court of South Carolina be denied.

OPINIONS BELOW

Several decisions have lead to NCR's Petition. The first decision was made by the South Carolina Tax Commission as an administrative body on January 22, 1988. That decision is unreported and is found at Pet. App. F at 68a-72a. NCR disagreed with that decision and brought an action in the Trial Court of South Carolina which resulted in a decision of the Court of Common Pleas of Richland County on February 22, 1989. That decision is unreported and is found at Pet. App. E at 42a-67a. NCR disagreed with the Trial Court's decision and appealed to the South Carolina Supreme Court. On February 4, 1991, the South Carolina Supreme Court, in a reported decision found at 304 S.C. 1, 402 S.E. 2d 666 (1991), issued an opinion which required the remand of the matter to the Trial Court. This opinion of the South Carolina Supreme Court (NCR I) which required the remand is found at Pet. App. D at 26a-41a.

After a trial pursuant to the remand was concluded, the Trial Court, on November 26, 1991, issued its decision. That decision is unreported and is found at Pet. App. C at 10a-25a. NCR sought to have the remand decision amended, and such request resulted in the Trial Court issuing a Supplemental Order on Remand on July 11, 1992. The Supplemental Order is not reported and is found at Pet. App. B at 8a-9a. NCR disagreed with the Trial Court's conclusions and appealed to the South Carolina Supreme Court a second time. The South Carolina Supreme Court, on December 13, 1993, issued an opinion reported as *NCR Corp. v. South Carolina Tax Com'n*, 439 S.E.2d 254 (1993). That decision (NCR II) is found at Pet. App. A 1a-7a. NCR has disagreed with the conclusions of NCR II and has filed a Petition for Writ of Certiorari.

JURISDICTION

The jurisdiction in this Court is found at 28 U.S.C. Section 1257(a).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

U.S. CONST. art. I, Section 8, cl. 3, states in part the following:

> The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

The U.S. CONST. amend XIV, Section 1 states in part the following:

> No State shall . . . deprive any person of life, liberty, or property, without due process of law.

STATEMENT OF THE CASE

NCR is a multinational corporation in the business of developing, manufacturing, marketing, installing and servicing of business information processing systems. The business is extensive and is not isolated by location. In fact, all phases of NCR's business are conducted in South Carolina. Its operations in South Carolina include a West Columbia plant which develops, manufactures and markets NCR's line of Tower computers. Additionally, NCR's plant in Liberty, South Carolina, manufactures personal computers, and its operation includes several retail and service offices in South Carolina,

including offices in Columbia and Greenville. Products produced in South Carolina are distributed and sold throughout NCR's worldwide market.

NCR and its subsidiaries are a unitary operation, and in conducting its unitary business, NCR receives royalty income. The royalty income in dispute in this case is received from unitary foreign subsidiaries pursuant to patent licensing agreements, under which NCR authorizes the foreign subsidiary to manufacture and sell NCR's patented machines. Ownership in the foreign subsidiaries is normally 100% by NCR, with the exception of NCR's subsidiary in Japan, which has 70% ownership. The royalties which are in dispute here are received by NCR from its unitary foreign subsidiaries and are in the following amounts:

1981	1982	1983
$32,996,316	$39,242,371	$49,992,119

Interest income is also received as a part of its unitary business. NCR finances its foreign subsidiaries' accounts receivable and makes direct loans to them. In addition, NCR has funds deposited in foreign countries and derives interest income. The interest income in dispute is as follows:

1981	1982	1983
$18,304,080	$23,924,409	$16,562,396

NCR argues its rights under the Foreign Commerce Clause and Due Process Clauses are violated by South Carolina's statutory taxing scheme.

REASONS FOR DENYING THE REQUESTED WRIT

I. THE FOREIGN COMMERCE CLAUSE IS NOT VIOLATED WHEN A STATE TAXES AN APPORTIONED SHARE OF ROYALTY AND INTEREST INCOME WHERE SUCH INCOME IS PART OF THE TAXPAYER'S UNITARY INCOME AND WHERE THE STATE UTILIZES THE STANDARD THREE-FACTOR FORMULA IN ARRIVING AT THE STATE'S APPORTIONED SHARE OF THAT UNITARY INCOME.

NCR asserts South Carolina taxes NCR's royalty and interest income on an apportioned basis while the same income is taxed on an unapportioned basis by the foreign countries in which NCR does business. (Pet. p. 13) NCR concludes such taxation is inevitable multiple taxation in violation of the Foreign Commerce Clause. In NCR's view, double taxation is inevitable in the instant case since "we are not dealing here, as the Court was in *Container*, supra, with two different methods of 'divid[ing] the pie.' Rather, here (as in *Japan Line*) the entire pie has been subjected to tax by foreign jurisdictions, which leaves the states no room to tax even an apportioned slice." (Pet. p. 15)

NCR's argument fails for two reasons. First, in the instant matter, any potential multiple taxation is not inevitable. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983), is controlling here since just as in *Container*, supra, South Carolina and the foreign countries are merely dividing the same pie (the income of NCR) by different methods. One method that may potentially produce multiple taxation is not required to yield to another that may also create multiple taxation.

Second, NCR's multiple taxation argument is premised upon a showing that the State and the foreign jurisdiction are taxing the same income. The mere fact that the royalty and interest income taxed by the foreign countries is also in the pre-apportioned base used by South Carolina to calculate South Carolina's share of unitary income does not mean multiple taxation of the same income is present. Accordingly, there is no multiple taxation at all. (Pet. pp. 48a-50a)

A. No Inevitable Multiple Taxation Occurs.

Under a Foreign Commerce Clause analysis, a property tax is in danger of being stricken if it "creates a substantial risk of international multiple taxation, . . ." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451, 99 S.Ct. 1813 (1979). In applying this test to an income tax, the Court has modified the standard by stating that a "method of formula apportionment [that] 'inevitably' led to double taxation . . . might be reason enough to render it suspect." *Container*, supra, 463 U.S. at 195. In this case, NCR asserts South Carolina's formula is not only suspect but is also unconstitutional.

1. *Container*, Supra, Prevents A Conclusion Of Inevitable Multiple Taxation Here.

As to the test of whether inevitable multiple taxation results, the Court in *Container Corp. v. Franchise Tax Bd.*, supra, resolved this issue when an income tax is apportioned under the standard three-factor formula such as that used by South Carolina. NCR is in error when it relies upon *Japan Line*, supra, as authority for its position.

In *Container*, supra, the parent corporation owned foreign subsidiaries whose earnings were purportedly taxed by the foreign governments in which they were located. The taxpayer, in *Container*, supra, contended that the *Japan Line* doctrine of

preventing international multiple taxation was violated because the California combined report method attributed a portion of the subsidiary earnings to California where they would be taxed again.

The Container Court acknowledged the similarity to Japan Line and stated that multiple taxation had occurred "in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part." 463 U.S. at 187, 77 L.Ed.2d at p. 567. This multiple taxation, as in *Japan Line*, "stems from a serious divergence in the taxing schemes adopted by California [or South Carolina] and the foreign taxing authorities." **Ibid.** "In addition, the taxing method adopted by those foreign taxing authorities is consistent with accepted international practice," namely, the arms-length separate accounting method, as opposed to unitary formula apportionment methods adopted by California and South Carolina. What is most significant is that even though *Container*, supra, found that multiple taxation did occur, the Court still found no violation of Foreign Commerce and distinguished *Japan Line* on three grounds.

First, *Container*, unlike *Japan Line* "involves a tax on income rather than a tax on property." 463 U.S. at 187-8, 77 L.Ed.2d at p. 568. The Container Court noted that the "reasons for allocation to a single situs that often apply in the case of property taxation carry little force in the case of income taxation." 463 U.S. at 188, 77 L.Ed 2d at p. 568.

Second, the Container Court stated that "the double taxation in this case, although real, is not the inevitable result of the

California taxing scheme." Ibid. The Container Court noted:

> In Japan Line, we relied strongly on the fact that one taxing jurisdiction claimed the right to tax a given value in full, and another taxing jurisdiction claimed the right to tax the same entity in part--a combination resulting necessarily in double taxation. Id., at 447, 452, 455, 60 L.Ed.2d 336, 99 S.Ct. 1813. Here, by contrast, we are faced with two distinct methods of allocating the income of a multinational enterprise. The "arms-length" approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization. Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case.

Ibid.

Likewise, South Carolina, in including unitary foreign interest and royalties in NCR's pre-apportioned net income base, has not thereby inevitably taxed such income so as to subject it to multiple taxation by South Carolina and the foreign governments. There is no distinction between operating income of a foreign subsidiary and interest or royalties paid by such subsidiary. *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980); *Container Corporation of America v. Franchise Tax Board,* supra. In fact, inclusion of income in the taxpayer's apportionable unitary net income base has been held by this Court as not being a tax directly on specific income in that base. Rather, the tax is on unitary income. *Shell Oil Company v. Iowa Department of Revenue,* 488 U.S. 19,109 S.Ct. 278,

102 L.Ed.2d 186 at p. 199 (1988); *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978). Contrary to NCR's multiple taxation argument, there is no inherent multiple taxation of NCR's income by South Carolina and a foreign country. The use of a method that taxes NCR's income under a "source nation" method of taxation (see Pet. p. 49a) cannot prohibit South Carolina from taxing NCR's income under a unitary approach. Under *Container*, supra, no violation of Foreign Commerce results.

Third, the Container Court distinguished Japan Line with an observation equally applicable to NCR in that "the tax here falls, not on the foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States." 463 U.S. at p. 188, 77 L.Ed.2d at p. 568. The Container Court stated that it had specifically left open in *Japan Line* the application of that case to domestically owned instrumentalities engaged in foreign commerce. 463 U.S. at 188-9, 77 L.Ed.2d at p. 568. The Container Court found that these three "distinctions" between *Japan Line* and *Container* "add up to a constitutionally significant difference." 463 U.S. at p. 189, 77 L.Ed.2d at p. 568. Thus, no Foreign Commerce Clause violation can be established by NCR.

Contrary to NCR's perception of *Japan Line*, the Container Court noted that an absolute rule prohibiting multiple taxation at the international level was not a proper reading of that case. Instead, the Container Court stated in 463 U.S. at p. 189, 77 L.Ed.2d at p. 569 that:

> . . . such an absolute rule is no more appropriate here than it was in Japan Line itself, where we relied on much more than the mere fact of double taxation to strike down the state tax at issue. Although double

> taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing State.

The Trial Court correctly analyzed the multiple tax issue when it relied upon the "context" of the double taxation and the "alternatives reasonably available" to South Carolina as set forth by *Container*, supra, to avoid the double tax. (Pet. pp. 51a-52a) First, South Carolina could eliminate the double tax by not taxing NCR at all. In fact, this is precisely what NCR seeks. The Container Court dismissed this argument summarily by finding that the "obvious unfairness" of such a rule" requires no elaboration." *Container*, supra, 463 U.S. at p. 190. Second, South Carolina could adopt the arms-length approach used by the foreign countries. Container dismissed this alternative since under an arms-length approach "the possibility of double taxation also exists." *Container*, supra, 463 U.S. at p. 191. In short, *Container*, supra, found the apportionment of unitary income such as NCR's royalty and interest was no more susceptible to double taxation than was the arms-length approach advocated by NCR.

> Thus, even if [South Carolina] were to adopt some version of the arms-length approach, it would not eliminate the risk of double taxation of corporations subject to its [income] tax and might, in some cases, end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

463 U.S. at p. 191.

These conclusions of the Container Court are equally applicable to NCR's foreign interest and royalties, and *Japan Line*, which

forbade multiple property taxation on the international level, is not applicable in the instant case and provides no support to NCR. *Container* is dispositive.

2. States That Have Applied *Japan Line*, Supra, Have Given It The Narrow Construction Intended By *Container*, Supra, And Such Results Demonstrate There Is No Confusion As To The Application of *Container*, Supra.

Application of *Japan Line*, supra, in the state courts, in the context of an income tax has been to limit the scope of the decision in accordance with *Container*, supra. As the following cases show, no support among sister states can be found for NCR's reliance upon Japan Line to support its multiple taxation view.

The most notable case is litigation by NCR in Minnesota. In *NCR Corp. v. Com. of Revenue*, 438 N.W.2d 86 (1989), NCR received royalties and dividends from its subsidiaries and, as is the case here, NCR and its subsidiaries operated as a unitary business. NCR claimed that taxing its royalty and dividend income violated the Foreign Commerce Clause since it was subject to income withholding tax on its foreign royalties and dividends by the foreign countries in which its subsidiaries operated. The Court dismissed NCR's double taxation argument by relying upon the *Container* rationale. In a somewhat less direct case, Oklahoma also declined to apply *Japan Line* in a broad manner. There a corporate income taxpayer claimed a deduction for taxes paid to foreign countries. The Tax Commission disallowed the deduction. The Court declined to apply *Japan Line* and held that the taxation of instrumentalities of foreign commerce was of limited applicability to the taxation of income. *Matter of Income Tax Protest of Flint Resources*, 780 P.2d 665, 671 (1989).

Finally, even in a pure property tax context, California has given a limited impact to Japan Line. In *Star-Kist Foods, Inc. v. County of Los Angeles,* 719 P.2d 987 (1986), the issue was whether an exemption on business inventories only for taxpayers involved in exporting and importing was a violation of the Commerce Clause. In finding the statute unconstitutional, the Court recognized the ability of the State to tax foreign commerce and distinguished *Japan Line* by holding that *Japan Line,* supra, was limited to the narrow circumstances presented in that case. *Star-Kist Foods,* 719 P.2d at p. 994.

As *Container,* supra, and the state courts have held, *Japan Line,* supra, has very little application to the instant case before this Court. Accordingly, the South Carolina Supreme Court properly relied upon *Container,* supra, in finding South Carolina's tax system did not result in an enhanced risk of multiple taxation so as to offend the Foreign Commerce Clause.

3. The Facts Of This Action Demonstrate There Is No Inevitable Multiple Taxation.

NCR asserts there is "dead certainty" that South Carolina's taxing method will create international multiple taxation. (Pet. p. 16) Such a conclusion is simply not true under the standard three-factor formula used by South Carolina.

"Inevitable" means incapable of being avoided or prevented. *American Heritage Dictionary,* Houghton Mifflin Company, 1976 Edition. Thus, the statement of "inevitable multiple taxation" must hold true for all fact situations involving NCR's patent and loaning activities. In at least two instances, the formula will not only prevent double taxation but will in fact reduce NCR's taxes.

NCR conducts extensive development activities. Not all

expenditures result in a profitable product in that a patent may be obtained at great cost and result in very little value. Other expenditures may result in failure with no income resulting. In short, NCR may create more expenses than it creates income. Clearly, NCR benefits under the formula. The expenses are deductions and deductions reduce NCR's income. Since the formula does not include the subsidiaries' factors, the deductions are not reduced by having to apportion the deductions to the foreign countries. Rather, a greater percentage of the deductions is apportioned to South Carolina and, thus, NCR's South Carolina tax liability is reduced.

NCR could prevent the "overtaxation" by simply transferring ownership of the patents to the subsidiaries. Under this arrangement, when NCR uses the patents, NCR would pay royalties to the subsidiaries. NCR itself would produce substantial deductions from royalties paid. These royalties paid would reduce NCR's net income. The percentage apportioned to South Carolina, not being diminished by the foreign factors, would apportion more of the deductions to South Carolina, thereby reducing the net income taxable in South Carolina. Accordingly, the formula would reduce NCR's South Carolina tax liability. Thus, again, the formula does not always and inevitably over tax NCR.

B. South Carolina's Unitary Taxation Does Not Tax The Same Income As That Taxed By The Foreign Countries And, Thus, There Is No Multiple Taxation.

NCR's multiple taxation argument is premised upon a showing that the State and the foreign jurisdiction are taxing the same income. The alleged proof of the taxation by South Carolina of the interest and royalty income is that such income is in the pre-apportioned base used by South Carolina to

calculate South Carolina's share of unitary income. Further, there is the assertion by NCR that the income included in the pre-apportioned base is foreign income. The inclusion in the pre-apportionment base does not mean multiple taxation of the same income is present nor does it mean that the income so included is foreign income. (Pet. pp. 48a-50a)

1. South Carolina Taxes Unitary Income Without Consideration As To Source.

NCR's view is that where ". . . the entire pie has been subjected to tax by foreign jurisdictions, . . . the state [has] no room to tax even an apportioned slice." (Pet. p. 15) NCR apparently agrees that *Container*, supra, is properly decided and, thus, it is proper for both foreign and state jurisdictions to tax a portion of the whole pie. (Pet. pp. 14-15) Such a view is tantamount to holding that a state may not tax income that is "foreign" (i.e. taxed by a foreign jurisdiction) unless the state taxes the income on the combined unitary method approved by *Container*, supra. Such a view creates two erroneous results. First, it forces those states using the unitary taxing method to chose the same method, i.e. the combined unitary method employed by a state like California. Second, NCR's view requires identifying the source of income in order to determine the taxability of that income.

a. No Standard Form Of Unitary Taxation Has Been Imposed By This Court.

The Supreme Court has never required a standard formula for employing the unitary method of taxation. This Court has found that the unitary concept "is not, so to speak, unitary; there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container*, 463 U.S. at 167, 77

L.Ed.2d at p. 555. Three methods are generally used with approval.

A state could select a unitary formula method whereby the taxpayer's apportionable unitary income base is limited to the taxpayer's operating income, whether from domestic or foreign sources. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n.*, 266 U.S. 271, 45 S.Ct. 82, 69 L.Ed. 282 (1924); *Underwriter Typewriter Co. v. Chamberlain*, 254 U.S. 113, 41 S.Ct. 45, 65 L.Ed. 165 (1920). Or, a state could validly select a method, as has South Carolina, whereby the taxpayer's apportionable unitary income would include operating income and investment income, whether from domestic or foreign sources. *Mobil Oil Corp. v. Commissioner of Taxes*, supra; *M. Lowenstein Corp., et al. v. South Carolina Tax Commission*, 298 S.C. 93, 378 S.E. 2d 272 (1989). Also, a state could select the combined report method whereby the entire net incomes of several commonly owned unitary corporations, whether domestic or foreign, are included in the taxpayer's apportionable unitary net income base. *Container Corporation of America v. Franchise Tax Board*, supra. A state is free to select whatever unitary method of taxation it feels is appropriate and has never been forced to adopt the combined method examined in *Container*, supra. NCR's view forces just such a result.

b. NCR's View Requires Identifying The Source Of The Income.

Whatever method the State selects to calculate the unitary income base, classification of the income as unitary income eliminates any consideration of the foreign source of the income. *Mobil Oil Corp. v. Commissioner of Taxes*, supra. Amounts included in apportionable income have no situs and to seek to find a situs is to literally destroy the very concept

upon which unitary/formula apportionment is based. This Court has previously rejected attempts to identify unitary income as having a particular situs.

In *Shell Oil Co. v. Iowa Dept. of Revenue,* supra, the taxpayer argued that Congress had forbidden states from taxing income earned on the Outer Continental Shelf (OCS) under the Outer Continental Shelf Lands Act (OCSLA). Shell, which conducted a unitary business of producing, transporting and marketing oil and gas, excluded the income it alleged was earned from oil produced on the OCS. Iowa included as part of the pre-apportioned income, the income allegedly earned from the OCS. In agreeing that Iowa was correct in including the income, this Court pointed out the fallacy of *Shell's* argument:

> Shell's argument hinges on the mistaken premise that including OCS-derived income in the preapportionment tax base is tantamount to the direct taxation of OCS production. But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa. As our Commerce Clause analysis of apportionment formulas has made clear, the inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation.

Shell, supra, at p. 284.

In other words, when income is included in the taxpayer's unitary base, the State is not taxing a specific class of income from a specific location. Rather, all classes of income (whether

originally foreign or domestic or whether from rent, royalty, interest, etc.) become a single type of income: unitary income. It is the unitary income that a state may constitutionally tax without regard to the alleged source or location of the income. See *Mobil Oil Corp. v. Commissioners of Taxes,* supra.

Amerada Hess Corp. v. Dir., N.J. Dept. of Treasury, 490 U.S. 66, 109 S.Ct. 1617 (1989), reiterated the position that income and deductions that are part of unitary net income are not assignable to a specific location. *Amerada Hess Corp. v. Dir., N.J. Dept. of Treasury,* supra, involved the attempt by the taxpayer to claim a deduction for its windfall profits taxes paid to the federal government. New Jersey disallowed the deduction since no deduction under New Jersey law can be allowed for taxes that are "on or measured by profits or income." The taxpayer countered by arguing that disallowing the deduction violated interstate commerce. The basis for this assertion was that since no oil was produced in New Jersey there would be no windfall profits taxes generated in New Jersey. Thus, the taxpayer reasoned that New Jersey was disallowing deductions generated in oil producing states and, therefore, caused New Jersey to "tax more than its fair share of the unitary income." *Amerada Hess,* supra, at p. 1622. In dismissing the taxpayer's argument, the Court stated the following:

> Appellants, however, underestimate the fact that, for apportionment purposes, it is inappropriate to consider the windfall profit tax as an out-of-state expense. Rather, just as each appellant's oil-producing revenue--as part of a unitary business--is not confined to a single State, Exxon Corp., 447 U.S., at 226; Brief for Appellants 8, so too the costs of producing this revenue are unitary in nature. See Container Corp., 468 U.S., at 182 (the costs of a unitary business cannot be deemed confined to the

> locality in which they are incurred). Thus, when a State denies a deduction for a cost of a unitary business, the resulting net figure is still a unitary one, which a State may legitimately decide to apportion according to the standard three-factor apportionment formula.

Again, the Court found the unitary nature of the income or deduction removed any consideration of where the income or deduction may have originated.

In the instant case, NCR is seeking to reassert the position denied in *Shell,* supra, and *Amerada Hess,* supra, by attempting to place a class of income and related expenses (here interest income and royalty income) at a specified location (here foreign countries). NCR has admitted its royalty and interest income is part of its unitary income. Such being true, there is no "foreign source" to such income. Rather, the income is properly apportionable under the now well established three-factor apportionment formula used for apportioning unitary income. See *Container Corp. of America v. Franchise Tax Board,* supra.

Thus, South Carolina has not taxed foreign source income and, accordingly, cannot be said to have taxed the same income that another jurisdiction has taxed. Rather, South Carolina taxes South Carolina's income, with such amount determined by a pre-apportioned base which includes various types of income from assorted transactions. NCR's assertion, throughout its Petition, that South Carolina has created multiple taxation misstates South Carolina's taxing system.

2. There Is Universal Agreement That Unitary Income Is Not Affected By The Source Of The Income.

The view that a particular class of income is somehow not

taxable because of the "source" of that income has been rejected in the state courts as well. In *Tenneco v. Com. of Rev.*, 516 N.E.2d 1164, 1168 (1987), the taxpayer carried on business in Massachusetts, but its foreign subsidiaries did not. The subsidiaries paid dividends which the taxpayer sought to exclude from income. The Court held that the mere labelling of the source of dividend income as foreign does not preclude a state from including that income in the pre-apportionment tax base. In *Comptroller v. Armco, Inc.*, 521 A.2d 785, 793 (1987), dividend and interest income was received by a parent from its subsidiary and the parent did not include them as income. In including the dividends and interest as part of the income base, the Court found that the character of the income prior to becoming part of unitary income had no relevancy to its taxability. Similarly, in *Hewlett-Packard Co. v. Dept. of Rev.*, 749 P.2d 400, 402 (1988), the issue was whether it was proper to include the income of foreign subsidiaries of a unitary business in a combined report when defining the limits of the unitary group and calculating the corporation's net income base. The Court found that the labelling of income as "foreign source" had no effect on its taxability.

II. WHERE A STATE TAXES THE UNITARY INCOME OF A RECIPIENT OF ROYALTY AND INTEREST PAYMENTS AND WHERE THE STATE USES THE STANDARD THREE-FACTOR FORMULA UTILIZED FOR UNITARY TAXATION, THE STATE IS NOT REQUIRED BY THE DUE PROCESS OR COMMERCE CLAUSES TO INCLUDE IN THE RECIPIENT'S FACTORS THE PAYROLL, PROPERTY AND SALES OF THE PARTY THAT PAID THE ROYALTY AND INTEREST.

NCR attacks South Carolina's formula on the ground that the formula is not properly reviewed under the gross disparity

test since South Carolina's formula is an "analytically indefensible apportionment regime...."(Pet. p. 23) In NCR's view, only "theoretically sound formulas" may employ the gross disparity test. (Pet. p. 23) According to NCR, South Carolina's formula is indefensible since it includes the royalty and interest income in the pre-apportionment base, but does not include the payroll, property and sales of the party that paid the royalty and interest. (Pet. pp. 17-18) NCR is incorrect in its view since it begs the question. The test has never been whether the formula is "theoretically sound" or "analytically indefensible." Rather, such labels only assume the answer in the framing of the label. The only acceptable test is whether "the factor or factors used in the apportionment formula . . . actually reflect a reasonable sense of how income is generated." *Container,* supra., 463 U.S. at 169.

A. Due Process And Interstate Commerce Are Not Violated Since South Carolina's Apportionment Formula Is Within the Requirements of Container, Supra.

Compliance with Due Process and Interstate Commerce is found by applying the following test set out by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board,* supra.

> . . . an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. See Exxon Corp., supra, 447 U.S. at 219, 227-228, 100 S.Ct. at 2118, 2122-2123; Moorman Mfg. Co., 437 U.S. at 272-273, 98 S.Ct. at 2343-2344; Hans Rees' Sons, Inc., 283 U.S. at 134, 51 S.Ct. at 389. The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency--that is, the formula must be

> such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency--the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not "invalidat[e] an apportionment formula whenever it **may** result in taxation of some income that did not have its source in the taxing State . . . "Moorman Mfg. Co., supra, 437 U.S. at 272, 98 S.Ct. at 2344 (emphasis added). See Underwood Typewriter Co., 254 U.S. at 120-121, 41 S.Ct. at 46-47. Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,'" [Hans Rees' Sons, Inc.] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [Norfolk & Western R. Co. v. State Tax Comm'n., 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)]. Moorman Mfg. Co., supra, 437 U.S. at 274, 98 S.Ct. at 2345.

NCR essentially challenges South Carolina's formula under the external consistency test.

B. External Consistency Is Satisfied Here Since The South Carolina Three-Factor Formula Reasonably Reflects South Carolina's Share Of The Unitary Income.

1. Inexactness Is Constitutionally Permitted.

The test of fairness under the Due Process and Commerce

Clauses requires satisfying an external consistency test which seeks to show that the apportionment factors "reflect a **reasonable** sense of how income is generated." (Emphasis added) *Container Corp.*, 463 U.S. at p. 169. In this formulation of the test, the Court underscores the view that the in-state factors in the formula are only to be reasonable. Exactness is not a requirement. In fact, to develop the view that rough approximations are valid, the Container Court identified the outer limits of what is reasonable by expressing the following at 103 S.Ct. at p. 2942:

> . . . we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is, in fact, 'out of all appropriate proportions to the business transacted . . . in that State,'" [Hans Rees' Sons, Inc.] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [Norfolk & Western R. Co. v. State Tax Comm'n., 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)]. Moorman Mfg. Co., supra, 437 U.S. at 274, 98 S.Ct. at 2345.

This Court has all but given blanket approval to the use of the three-factor formula in providing a fair apportionment of income. *Container Corp.*, supra, at 103 S.Ct. 2943; *Amerada Hess Corp. v. Director, New Jersey Dept. of Treasury*, supra.

It is in light of this extensive approval of the three-factor formula that NCR must conclusively demonstrate that South Carolina's apportionment is unfair in Due Process terms. NCR has a high burden of proof and must demonstrate there is no rational relationship between the income attributed to the State and the intrastate values of the enterprise, by showing the income apportioned to South Carolina is out of all

appropriate proportion to the business transacted in the State. *Container*, supra, 103 S.Ct. at 2948. That burden is not carried where the disparity is only 27.9%. (Pet. pp. 6a-7a)

2. NCR's Reliance Upon Justice Stevens' Dissent In *Mobil*, supra, Is Misplaced.

NCR relies upon Justice Stevens' dissent in *Mobil*, supra, 100 S.Ct. 1223 (1980). Its position is that the South Carolina apportionment factors do not reflect a reasonable sense of how income is generated unless the payroll, property and sales of NCR's subsidiaries are included with NCR's payroll, property and sales. This position is incorrect.

First, South Carolina is not taxing the income of the subsidiaries. Rather, the only income being taxed is the income of NCR itself. If the total income of the subsidiaries were taxed, it would be proper to include the subsidiaries' factors. Correspondingly, it is equally proper to not include the factors where none of the subsidiaries' income is taxed.

Second, *Mobil* concerned dividends rather than the royalty and interest income involved here. In the case of a dividend, the payment represents an actual part of the earnings of the subsidiary and it may be more appropriate in such a case to consider the factors of the subsidiary as a part of the apportionment formula; however, where the income paid out, such as royalty and interest, is a mere expense of the subsidiaries in performing their business in the foreign location, there are no "earnings" of the subsidiary that need to be accounted for in the factors of the recipient.

C. The State Court Decisions Cited By NCR Do Not Support NCR's Position.

1. *American Telephone and Telegraph Co. v. Wisconsin*

Dept. of Revenue, 422 N.W.2d 629 (1988), Is A Case Limited To Unique Facts And Was Decided Under The Gross Distortion Test.

AT&T is an interstate public utility which owns a substantial number of 100% subsidiaries from which it received dividends and interest. Wisconsin found these dividends and interest to be part of AT&T's unitary business and apportioned this income using the basic three-factor formula using only AT&T's property, payroll and sales.

AT&T argued that in order to comply with Due Process and the Commerce Clause, Wisconsin was required to include in the property factor of the formula, AT&T's book cost investment in and advances to its subsidiaries which it claimed generated the dividend and interest income.

In its Due Process analysis, the Court found that the Wisconsin formula was internally consistent since if all states used Wisconsin's formula, only 100% of the income of AT&T would be taxed. The Court concluded, however, that the formula was not externally consistent. The Court found that the amount of tax due in Wisconsin was out of proportion to the amount of business done in that state. AT&T's investment in subsidiaries was approximately $29.5 billion. Additionally, the subsidiaries paid about 75-80% of their net earnings annually to AT&T. In 1976, AT&T received $2,871,718,743 in dividend income from its subsidiaries. In fact, the bulk of AT&T's income was generated by subsidiaries which did no business in Wisconsin.

The Court found no problem with taxing this income since it was part of the integrated business of the taxpayer; however, the Court found that in this particular case, the apportionment formula does not bear a reasonable relation to the corporate

activities of the Bell System in Wisconsin. The taxes which are paid to Wisconsin are "grossly disproportionate to the benefits conferred."

It is important to note that the Lower Court found that AT&T's income in Wisconsin increased by 400% after the break-up. The Court did not strike down the apportionment formula; it simply found that the formula was not appropriate in this case. The test the Court applied was the "gross disparity test."

This gross disparity test was applied by the Trial Court in the instant case and it found 28% disparity. AT&T also applied the gross disparity test and it found a 400% disparity. The Court felt under the unique circumstances surrounding the break up of AT&T that such a disparity was too large. Obviously, no such unique circumstances are present in NCR and a 28% disparity is a far cry from 400%. AT&T does not support NCR's argument.

2. *Tambrands, Inc. v. State Tax Assesssor,* 595 A.2d 1039 (1991), Is Of No Support To NCR Since In The Instant Matter, There Is No Violation Of Internal Consistency.

Tambrands was a Delaware Corporation with its headquarters and commercial domicile in New York. It operated in a number of states, as well as having foreign affiliates in Canada, France and the United Kingdom. In 1984, *Tambrands* received $7,493,965 in dividends from its foreign affiliates.

Maine used the three-factor formula in conjunction with a "water's edge" unitary approach in taxing the income of Tambrands, including the dividends from the foreign affiliates. Tambrands argued that the property, payroll and sales of the foreign affiliates should have been taken into account in the

apportionment formula.

The Court looked at the *Container*, supra, internal and external consistency tests and concluded that the external consistency test was not violated. The distortion of income was 14.9% which, according to the Court's footnote citing *Container*, is "within the substantial margin of error inherent in any method attributing income among the components of a unitary business." The Court, therefore, found that the tax did not violate the external consistency test.

The Court found that the internal consistency test, however, was violated because the dividend income was being taxed by the foreign country, as well as the United States. In the instant case, there is no violation.

The proper application of the test is to apply the test as though every jurisdiction, foreign and domestic, used South Carolina's apportionment formula. If all jurisdictions used the identical three-factor formula South Carolina uses, only 100% of NCR's income is taxed. This is true since each jurisdiction would receive a portion of the income based only on the percentage of the payroll, property and sales in their taxing jurisdictions. Accordingly, no more than 100% of the income could ever be taxed.

Here, the royalty and interest income are not taxed twice. South Carolina gives a deduction for the payment of the royalty and the interest, and such income is taxed only once. That tax is upon the receipt by NCR. Thus, there is no violation of internal consistency.

There is no violation in the instant case.

3. *Homart Development Co. v. John H. Norber, Tax Administrator*, 529 A.2d 115 (1987), Is Of No

Assistance To NCR Since *Homart* Is A Partnership Case In Which A Flow Through Approach Was Used And Is Not Relevant To A Corporate Taxpayer.

Homart Development Company was a Delaware Corporation with its commercial domicile in Illinois. Homart was engaged in the development of shopping centers both inside and outside of Rhode Island. Homart was also the general partner in several partnerships which were also engaged in real estate development. Homart's general partnership activities were conducted outside the State of Rhode Island. Rhode Island contended that the income from Homart's general partnerships should be included in the overall corporate income of Homart; however, the payroll, property and sales of the partnership interests should not be included in Homart's apportionment formulas.

Rhode Island contended that this treatment was proper under the separate entity theory. Since the partnerships were separate entities, the partnership factors should not be used in determining corporate apportionment. The Court found that Rhode Island's apportionment method did not fairly reflect the business which was carried on in the State of Rhode Island and required that the property, payroll and sales of the partnerships be considered in apportioning the income.

This decision is correct and is consistent with South Carolina law. For South Carolina tax purposes, property, payroll and sales of partnerships pass through to the partner to be considered in the partner's apportionment formula.

The vital distinction between Homart and NCR is that the partnership is a pass through entity; therefore, all income of the partnership is passed through and the recipient is taxed while the partnership itself is not taxed. In the case of NCR,

South Carolina does not tax any of the net income of the subsidiaries. Thus, consistent with *Homart*, South Carolina would not include any of the payroll, property and sales of the subsidiaries.

D. An Argument That A Formula Creates An Inevitable Overtaxation Of NCR Carries No Constitutional Importance Where The Formula Is The Well Accepted Three-Factor Formula.

NCR argues that the formula used in South Carolina inevitably results in overtaxation. NCR is incorrect for obvious reasons.

NCR asserts it will always be overtaxed every year unless South Carolina gives greater weight to representing the royalty and interest income in the denominator of the formula. All that is required of the State is that the formula "reasonably represent the activities carried on in the State." *Moorman*, supra.

South Carolina in its formula has allowed factor consideration for the royalty and interest by an adjustment that increases the sales denominator by including the royalties and interest. Such a practice is a sufficient factor representation and is one employed in close to thirty states. To vary from the standard practice and to grant greater weight in the formula must be established by application of the "gross disparity" test of Due Process.

NCR asserts the alleged overtaxation is due to the structure of the formula itself. It assumes that showing the formula is flawed is the same as showing the formula is inherently unconstitutional. Nothing could be further from the truth.

The three-factor formula has been conclusively found to be

fair and is the benchmark against which other apportionment formulas are judged. *Container*, supra, at p. 2943. Yet even the "benchmark" is inherently flawed and has been specifically identified as being imperfect for at least three reasons.

> First, the one-third-each weight given to the three-factors is essentially arbitrary. Second, payroll, property, and sales still do not exhaust the entire set of factors arguably relevant to the production of income. Finally, the relationship between each of the factors and income is by no means exact.

Container, supra, at p. 2950, ftn. 20.

Despite these serious problems, the Court has found such a formula to be fair. Thus, whether South Carolina's use of the three-factor formula "always overtaxes" is not the relevant question since the three-factor formula always has inequities. *Container*, supra. Even if the formula did overtax, the test is still whether the taxpayer can show a gross disparity. NCR has shown no gross disparity, and thus, the Petition should be denied.

CONCLUSION

The Petition for Certiorari should be denied.

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April 11, 1994

Supreme Court, U.S.
FILED
APR 22 1994
OFFICE OF THE CLERK

No. 93-1416

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

NCR CORPORATION,
Petitioner,
v.
SOUTH CAROLINA
DEPARTMENT OF REVENUE AND TAXATION,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of South Carolina

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

Respondent's brief in opposition seeks to avoid this Court's review of the decision below by arguing that whether South Carolina's use of its three-factor formula " 'always overtaxes' is not the relevant question . . . ." Opp. at 29. To the contrary, in the context of this Court's Foreign Commerce Clause jurisprudence, the question whether the state's formula always or inevitably results in multiple taxation is not only relevant but decisive, and its presence here calls for this Court's consideration. Due process concerns also require that a formula not systematically overtax but reasonably reflect how income is generated. Simply put, because South Carolina includes previously taxed royalties and interest received by NCR from its unitary foreign subsidiaries in NCR's apportionable income without taking into account the "proportionate measure . . . of the foreign subsidiaries' property, payroll, and sales which generated the NCR income" (Pet. App. D at 40a [1]), South Carolina's formula inevitably overattributes income to South Carolina and creates inevitable international multiple taxation in violation of the Due Process and Foreign Commerce Clauses. By using apportionment factors that are incommensurate with the tax base, the formula is inherently defective and incapable of satisfying the constitutional prescription that it fairly apportion NCR's income to South Carolina.

Instead of confronting this critical defect in South Carolina's formula, respondent contends that no inevitable multiple taxation occurs because (1) the Court's decision in *Container* prevents such a conclusion (Opp. at 5-11), (2) South Carolina is not taxing the royalties and inter-

[1] As described in the petition, this case was remanded in *NCR I* for a refactoring of the formula to take into account this "proportionate measure" of the foreign subsidiaries' factors. As found by the trial court on remand, failure to include the subsidiaries' out-of-state factors that helped generate NCR's apportionable income caused NCR's South Carolina income to be increased by an average of $61,000 or 28% during the years at issue. Pet. App. C at 21a.

est merely by including them in the apportionable tax base (*id.* at 8, 16-18), and (3) South Carolina is merely taxing unitary income whose source cannot be identified. *Id.* at 13-19. Respondent further contends that NCR has no right to factor representation, even if the formula is " 'analytically indefensible' " (*id.* at 20) and " 'always overtaxes' " (*id.* at 29), because, in respondent's view, NCR is entitled to relief only if it can demonstrate a "gross disparity" (*id.*) in the resulting tax.

As we demonstrate below, each of these contentions is wrong for the same reason, namely, respondent's failure to recognize that the principles it espouses, and the authorities it cites, are all predicated on the existence of income tax regimes under which the factors that generate the income being apportioned are included in the apportionment formula. In advancing its arguments, respondent ignores the fact that South Carolina's taxing regime provides for no such factor representation. With this predicate removed, respondent's arguments collapse.

I. *CONTAINER* DOES NOT CONTROL THE ISSUE OF INEVITABLE MULTIPLE TAXATION AS PRESENTED IN THIS CASE

Respondent is simply wrong in suggesting that *Container* "is controlling here since just as in *Container* . . . South Carolina and the foreign countries are merely dividing the same pie (the income of NCR) by different methods." Opp. at 5. Since California required unitary corporations to file a worldwide combined report, the "pie" which was subject to division by California and foreign jurisdictions in *Container* was the combined unitary operating income of Container and all of its domestic and foreign subsidiaries. California divided the pie by formulary apportionment, while foreign jurisdictions divided the pie using an arm's-length separate accounting approach. Although the juxtaposition of those two methods resulted in actual international multiple taxation, this Court correctly determined that this result was not

inevitable. Because the combined reporting method used by California took into account all of the factors of the foreign subsidiaries that contributed to the apportionable combined "pie," it was not inevitable that the foreign subsidiaries' operating income would be attributed to California.

Unlike California, however, South Carolina does not utilize worldwide combined reporting; therefore, in contrast to *Container*, the "pie" in this case cannot be the combined unitary operating income of NCR and its subsidiaries. Rather, the "pie" consists of the interest and royalty income received by NCR from its foreign subsidiaries. While South Carolina taxes only an apportioned share of NCR's royalties and interest, foreign jurisdictions subject the entire amount of this income to tax. In other words, South Carolina taxes a piece of the "pie" but the foreign jurisdictions tax the whole thing. Thus, in contrast to *Container*, juxtaposition of these two methods here inevitably results in international multiple taxation.[2]

II. BY INCLUDING NCR'S INCOME FROM FOREIGN SUBSIDIARIES IN THE APPORTIONABLE TAX BASE WITHOUT INCLUDING THE FOREIGN SUBSIDIARIES' FACTORS IN THE APPORTIONMENT FORMULA, SOUTH CAROLINA INEVITABLY TAXES A SHARE OF SUCH FOREIGN SOURCE INCOME

Respondent contends that South Carolina is not taxing the royalty and interest income that NCR receives from its foreign subsidiaries merely because it includes such income in NCR's apportionable tax base. Opp. at 8,

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[2] One could also define the "pie" to be all the income of NCR, which would include the royalties and interest received from its foreign subsidiaries, but would exclude the operating income of those subsidiaries. This "pie" is also significantly different from that in *Container* because it includes only the separate income of NCR, not of NCR's combined worldwide unitary group of corporations. More importantly, however, an analysis based on this "pie," although slightly more complicated, still leads to the same conclusion regarding inevitable multiple taxation.

16-17. Invoking this Court's decision in *Shell Oil Co. v. Iowa Department of Revenue*, 488 U.S. 19 (1988), respondent misconceives NCR's argument as " 'hing[ing] on the mistaken premise that including . . . income in the preapportionment tax base is tantamount to the direct taxation' " of such income. *Id.* at 30 (quoted in Opp. at 16). Rather, " '[o]nly the fraction of total income that the apportionment formula determines . . . to be attributable to [the state's] taxing jurisdiction is taxed by [the state].' " *Id.* (quoted in Opp. at 16).

NCR agrees that including income in the preapportionment tax base is not the same thing as taxing such income. But that principle has no bearing here because it applies *only* if all of the factors that generate the apportionable income are included in the apportionment formula. Thus in *Shell*, the Court's conclusion that the state was not taxing income from Shell's operations on the Outer Continental Shelf merely because such income was included in Shell's apportionable tax base was reached only because the out-of-state factor [3] that generated the apportionable income was likewise included in the formula employed to apportion Shell's income to the state. *Shell*, 488 U.S. at 22 n.3, 23 n.4.

Similarly, in *Container*, on which respondent places such heavy reliance, the Court concluded that, merely because California required Container to include income earned by its foreign subsidiaries in the apportionable tax base, California was not thereby taxing the same income on which Container's foreign subsidiaries had paid tax abroad. While inclusion of the foreign subsidiaries' income caused Container's apportionable tax base to increase, inclusion of the subsidiaries' factors caused its apportionment percentage to decrease. Depending on the relative impact of these two changes, the income apportioned to California could have increased, decreased, or remained the same. *See* Pet. at 15 n.11.

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[3] Unlike most states which employ a three-factor formula of property, payroll, and sales for apportioning net income, Iowa employs a single-factor sales formula to apportion income to the state.

In striking contrast to the apportionment schemes at issue in both *Shell* and *Container*, South Carolina's taxing scheme insures that inclusion in the apportionable tax base of the income under consideration will lead to the taxation of such income. Unlike Iowa in *Shell* and California in *Container*, South Carolina did not include all of the factors that generated the income in question in the apportionment formula. Consequently, while NCR's apportionable tax base was increased by the inclusion of the royalties and interest, there was no change in its South Carolina apportionment percentage to account for the factors of NCR's subsidiaries that generated such royalties and interest. Pet. App. D at 29a. When there is an increase in apportionable income, and the apportionment percentage remains the same, it is a matter of mathematical certainty that an apportioned share of the additional income will be taxed.

III. THE SOURCE OF NCR'S INCOME HAS NO BEARING ON ITS CLAIM OF INEVITABLE MULTIPLE TAXATION

Much of respondent's brief in opposition is devoted to establishing that NCR is unable to identify the source of the royalty and interest income that it receives from its foreign subsidiaries. Respondent contends that the royalties and interest have no identifiable source because they are part of NCR's unitary income. From this premise, respondent argues that South Carolina is not taxing the same foreign source royalties and interest on which NCR pays taxes to foreign countries because "classification of the income as unitary income eliminates any consideration of the foreign source of the income." Opp. at 15. Accordingly, in respondent's view, NCR's claim of inevitable multiple international taxation must fail.

In fact, the source of NCR's royalties and interest is irrelevant to NCR's claim of inevitable multiple taxation. Inevitable multiple taxation of NCR's royalties and interest occurs due to the simple fact that the same royalties and interest—*regardless of their source*—are taxed

both by foreign countries and by South Carolina. Pet. App. D at 27a, 29a. Because South Carolina included the royalty and interest income in the apportionable tax base without adjusting NCR's apportionment formula to reflect the factors that generated such income, it inevitably taxed an apportioned share of the royalty and interest income. *See supra* pp. 3-5. Consequently, it is undeniable that, whatever the source of NCR's royalties and interest, South Carolina's taxing scheme inevitably results in the taxation of the same royalties and interest that are subjected to tax abroad.[4] In any event, it is plain that unitary income does have a source. It is earned in *all* of the jurisdictions in which the unitary business operates, and it can be traced to *all* of the business's property, payroll, and sales.

IV. RESPONDENT HAS OFFERED NO PRINCIPLED RESPONSE TO NCR'S CLAIM THAT THE FACTORS THAT GENERATED ITS ROYALTY AND INTEREST INCOME MUST BE REPRESENTED IN NCR'S APPORTIONMENT FORMULA

NCR contended in its petition that this case raises a question of great practical importance, which this Court left open in *Mobil* and which has subsequently divided state courts of last resort, namely, whether a state may include in a corporation's apportionable tax base income received from its unitary foreign subsidiaries without taking account of the subsidiaries' income-producing factors in the apportionment formula. NCR also pointed out that the failure to provide for factor representation in

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[4] Indeed, the New Mexico Taxation and Revenue Department, which has opposed NCR's pending petition for certiorari in a case that is virtually identical to this one, explicitly concedes that "[e]ach foreign nation's allocation to itself of all of NCR's income earned in that nation will always and necessarily overlap with every state's apportioned tax system." Opp. at 10, *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico*, No. 93-541. Despite the differences between New Mexico and NCR on other issues, both parties agree on the critical fact that the state is seeking to tax the very same royalties and interest that have been taxed abroad.

such circumstances would inevitably attribute too much income to the taxing state.

Respondent makes no effort to defend South Carolina's apportionment scheme on the merits. Instead, respondent claims it is irrelevant whether South Carolina's "formula is 'theoretically sound' or 'analytically defensible' " (Opp. at 20) or whether it " 'always overtaxes.' " *Id.* at 29. The only "relevant question" (*id.*), according to respondent, is whether the formula creates a "gross disparity." *Id.* In fact, the truly relevant question—and the one that demands this Court's attention—is whether the "relevant question" that respondent would answer is all that the Constitution requires.

Although NCR believes that respondent is profoundly misguided in its view of the law, *see* Pet. at 22-23, respondent's position in any event demonstrates the need for the Court's review of this case. Only this Court can resolve the question whether the good-enough-for-government-work defense espoused by respondent is a constitutionally sufficient answer to the systematic overtaxation to which South Carolina's taxing regime subjects NCR. Only this Court can determine whether the powerful case for factor representation advanced by Justice Stevens in his dissent on the question the Court left open in *Mobil* may be ignored by state courts. And only this Court can resolve the conflict between those state courts that have embraced Justice Stevens' views and those, like the court below, which have rejected it.

Several points that respondent offers in defense of South Carolina's taxing scheme nevertheless warrant brief attention. First, respondent claims that South Carolina "has allowed factor consideration for the royalty and interest by an adjustment that increases the sales denominator by including the royalties and interest." Opp. at 28. This defense fails because merely including the intangible income that NCR receives from its unitary foreign subsidiaries in NCR's sales factor—rather than including the factors of the subsidiaries themselves—does not reflect how income is generated. As the Court ob-

served in *Container*, "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container*, 463 U.S. at 169. The minuscule adjustment that South Carolina actually made in NCR's apportionment percentage (*e.g.*, 0.4% for 1981) does not begin to reflect the contribution that the subsidiaries made to NCR's apportionable income (*e.g.*, 67% for 1981). Pet. at 22 n.14.

Second, respondent seeks to distinguish this case from *Mobil* on the ground that this case involves royalties and interest rather than dividends. "[W]here the income paid out, such as royalty and interest, is a mere expense of the subsidiaries in performing their business in the foreign location, there are no 'earnings' of the subsidiary that need to be accounted for in the factors of the recipient." Opp. at 23. Respondent's argument loses sight of the rationale on which it is taxing NCR's royalties and interest. The only reason that the royalties and interest are includible in NCR's South Carolina tax base is because they arise out of NCR's unitary business conducted with its foreign subsidiaries. Whether the unitary income derived from NCR's foreign subsidiaries takes the form of dividends, interest, or royalties is constitutionally irrelevant. As the Court declared in *Mobil*, and, indeed, as respondent recognizes (Opp. at 8), it is the "underlying activity" not the "form of investment" that informs the constitutional rules in this domain. *Mobil*, 445 U.S. at 440. As long as the royalty and interest income derives from NCR's unitary business, as it admittedly does in this case, then the income is apportionable and the underlying factors that generate such income must be reflected in the apportionment formula.[6]

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[6] Respondent suggests that NCR's position is "tantamount to holding that a state may not tax income that is 'foreign' (i.e. taxed by a foreign jurisdiction) unless the state taxes the income on the combined unitary method . . . ." Opp. at 14. The suggestion is baseless. All NCR seeks is that the factors that generated such income be included in the apportionable tax base. This is a far cry from combined reporting, whereby South Carolina would include in the apportionable tax base the operating income of the foreign

Third, respondent's efforts to distinguish the cases that squarely conflict with the decision below lack substance. Respondent blatantly misstates the Maine Supreme Court's holding in *Tambrands* in suggesting (1) that the case turned entirely on the application of the "internal consistency" test and (2) that, because the distortion resulting from the lack of factor representation amounted to only 14.9%, the *Tambrands* court "concluded that the external consistency test was not violated." Opp. at 26. In fact the court declared that "[e]ven assuming that the Assessor's formula is constitutionally valid under the internal consistency test, it results in taxation of value extraterritorial to Maine and is contrary to due process . . . ." *Tambrands*, 595 A.2d at 1044; *see also* Pet. at 19-20.[6]

Respondent likewise misreads *American Tel. & Tel.*, in asserting that it was decided under the "gross disparity test" (Opp. at 25) rather than on the ground that the formula was inherently defective. In fact, the Wisconsin court in *American Tel. & Tel.* required a modification of the apportionment formula because "the apportionment formula used by the department does not reflect a reasonable sense of how A.T.&T.'s income is generated" (*AT&T*, 143 Wis. 2d at 551, 422 N.W.2d at 636), not because the application of the formula to the taxpayer produced a grossly distorted result. *See* Pet. at 20-21. As for *Homart*, respondent seeks to distinguish the case on the ground that it involves a partnership rather than a corporation. Opp. at 27-28. But it fails to explain why the principle underlying the case—that "inclusion of this income in Homart's net-income calculation . . . *necessarily* requires that the payroll, property, and receipt factors that gave rise to it be included in the apportionment equation also" *Homart*, 529 A.2d at 121 (emphasis supplied)—is

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subsidiaries, and the royalties and interest at issue would be eliminated as intercompany items.

[6] Even the New Mexico Taxation and Revenue Department, which has opposed NCR's petition for certiorari in *NCR Corp. v. Taxation and Revenue Department, supra* (No. 93-541), concedes that *Tambrands* is in conflict with decisions denying a right to factor representation. Opp. at 15, *id.*

any less applicable to corporate entities than to partnerships.

Finally, respondent cannot resist yet another citation to *Container*, this time for the proposition that "[t]he three-factor formula has been conclusively found to be fair," Opp. at 28-29, and that it is therefore appropriate to measure the constitutionality of South Carolina's inexorable overtaxation only by the relaxed " 'gross disparity' test." *Id.* at 28. Respondent's argument once again stumbles over its own premises. To be sure, the standard three-factor formula employed by California in *Container* is similar to that used by South Carolina here. But respondent fails to recognize, as it has throughout its brief in opposition, that the three-factor formula the Court endorsed in *Container* as "fair" (*Container*, 463 U.S. at 169-70) was fair only because the formula included all of the factors of the subsidiaries whose income was being apportioned. Here, by contrast, the three-factor formula reflects only the activities of NCR itself and wholly fails to reflect any of the factors of the subsidiaries that generated NCR's royalty and interest income.

CONCLUSION

The petition for a writ of certiorari should be granted.

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